

Basel Committee of Banking Supervision

Division Bank and Insurance
Austrian Federal Economic Chamber
Wiedner Hauptstraße 63 | P.O. Box 320
1045 Vienna
T +43 (0)5 90 900-ext | F +43 (0)5 90 900-272
E bsbv@wko.at
W <http://wko.at/bsbv>

Your reference, Your message of

Our reference, contact person
BSBV 189/Dr. Egger

Extension
3137

Date
21st June 2016

BCBS - Reducing variation in credit risk-weighted assets - constraints on the use of internal model approaches

The Division Bank and Insurance of the Austrian Federal Economic Chamber, as representation of the entire Austrian banking industry, appreciates the possibility to comment on the above cited consultation paper and would like to submit the following position:

We appreciate the efforts of the BCBS to come up with proposals aimed at reducing the RWA variance, but we believe the current proposal would only partially achieve this goal, while causing major drawbacks like diminished ability of banks to assess and differentiate risk at the highest level of granularity, introducing anomalies for the low risk borrowers and increasing capital requirements above the levels the current models would indicate. In combining the new IRB-approach and the new STA-approach proposed by the BCBS the levels of RWA and EL (Expected Loss) of several banks would significantly increase without an indication that this is regulatory arguable, meaning that the riskiness of the portfolio would indicate that higher RWA and EL levels are justified. We also want to point out the additional pro-cyclical effect of these proposals.

Also in view of the developments in the last decade where regulators encouraged banks to invest into more advanced models it is hard to understand why the BCBS now wants to revert its strategy towards LDP (loss given default) modelling significantly. Instead of removing the modelling approach and in view of the overall goal of reduction in variation of RWA calculation we would encourage the BCBS to focus on improvements in the supervision of such models.

Some of our members have assessed the impact on RWA of the proposed changes to the IRB framework, in conjunction with the proposal for the changes to the standardized approach. The results of this analysis show a material increase on RWAs.

- Taking that into consideration we specifically do not support the following proposals:
 - o Removing the IRB approaches for banks and other financials and their treatment under the standardized approach for credit risk
 - o Introduction of PD and LGD floors
 - o Removing the treatment of Unconditionally Cancellable Commitments by a zero CCF

- The definition of “large corporates” as corporates belonging to consolidated groups with total assets exceeding 50 bn EUR, where the actual size of the balance sheet of the counterparty could be small
- The use of total assets as a first criterion for defining the size of a corporate instead of the currently used total sales.

Furthermore we would like to go into more detail regarding the “parameter estimation practices and fixed supervisory parameters”:

- PD floors:

According to the proposals of the BCBS banks using models would have to adjust their modelling methodology and redevelop models which in fact will also eventually trigger application to different EU regulators for approval of material changes in the IRB systems.

- LGD floors:

Similar to the PD floors, the application of LGD floors would require changes in several member institutions in the segmentation of existing LGD models, triggering possible application for approval of material changes in the IRB systems to several EU regulators.

“Rating systems should be designed in such a way that assignments to rating categories generally remain stable over time and throughout business cycles. Migration from one category to another should generally be due to idiosyncratic or industry-specific changes rather than due to business cycles.”

This more or less unambiguously implies that several banks could be expected to switch to a Through-the-cycle rating system philosophy as they currently apply a Point-in-time approach. Removing the option for the Banks to choose which of the rating philosophies to follow and imposing only a TTC approach is understandable from a capital steering point of view, but will certainly affect all those banks which intensively use the PIT approach for daily risk management purposes.

The following statement (see page 7 of the consultation paper) needs clarification:

“Modelled PD should be based on the observed historical average one-year default rate, which must include a representative mix of good and bad years, with a minimum weighting of data from downturn years of one in ten.”

One can infer that the average period should be at least 10 years whereby the downturn years in this time series should be at least one; if so then it is not clear whether in case the historical period with available default data is dominated by downturn years certain downturn years should be excluded to avoid introducing upward bias in the average. Moreover, if the minimum length of the historical time series should be at least ten years then several currently approved PD models for retail portfolios might be considered non-compliant with this requirement.

Concerning the granularity of PDs (see page 7 as well)

“[...] the Committee proposes to adjust the way in which seasoning is taken into account in the estimation of PDs for retail exposures. Currently, banks must adjust PD estimates upwards for anticipated seasoning effects. However, the Committee believes that instead of encouraging banks to adjust estimated PDs, they should instead be required to take account of seasoning as a risk factor in their models.”

Depending on the meaning of seasoning effect, the following possible implications can be identified:

- Seasonal effect understood as yearly cyclical behaviour of the portfolio - this should be addressed better through the requirements set on rating model development samples. This would have a minor implication on bank's retail methodology.
- Seasonal effect understood as the different pattern of default rates over the lifetime of a loan product - this is already taken into account within the existing Retail PD estimation methodology of one of our members.

It is worth noting that the seasoning effect cannot be taken into account within application (origination) rating models while in certain cases their rating outputs do constitute a significant percentage out of the totally rated portfolio within a month. Therefore the seasoning effect may be captured better when allowing for the adjustment of final PD parameter instead and not forcing certain variables within the rating model. Anyway, if the proposed requirement is enforced it will require a considerable change in current methodology of our member institutions.

The following statements concerning A-IRB: unsecured exposures (corporate and retail - see page 10, 4.2.3.) needs to be clarified:

"LGD will be the sum of two components: (i) long-run average LGD for each exposure, and (ii) the add-on to reflect the impact of downturn conditions"

Currently, the retail methodology of some institutions considers more components beside the long-run average LGD and the downturn add-on. Therefore a clarification is needed whether this statement implies a simplification of the LGD estimation methodology or if the statement is incomplete by missing the specification of the other margins, e.g. estimation error margin, margin for PD/LGD correlation, margin for lending practice changes, margin for collateral-currency mismatch and margin for collateral-obligor correlation.

"The downturn add-on component is inherently more subjective than the long-run average component. To limit the extent to which the component leads to undue variation in LGD estimates, the Committee will consider applying a floor to the downturn add-on. This floor would be in addition to the floor on the overall LGD set out in Section 3. As an alternative, the Committee is considering whether to use supervisor-specified add-ons for the downturn component."

In case of adopting a supervisor-specified add-on, it must be taken into account the fact that an absolute level setting can cause uneven effect for different LGD values - less risky portfolios could be affected more in relative terms. Nevertheless, the downturn impact should be assessed considering the bank's own experience during such periods since this is also highly depending on the effectiveness of its internal collection and workout processes. From RWA perspective this may cause a significant increase, while from a methodological point of view this is actually a simplification.

The third bullet point on page 11 with regard to EAD modelling reads as follows:

"Where EAD modelling continues to be permitted, it will be subject to the following constraints on EAD estimation practices:

o [...]

o A well-known feature of the commonly used undrawn limit factor approach to estimating CCFs is the region of instability associated with facilities close to being fully

drawn at the reference date. Banks should ensure that their EAD/CCF estimates are effectively quarantined from the potential effects of this region of instability.”

This potential additional requirement is actually endorsing a good practice already established in members’ Retail CCF estimation. The utilisation pattern referred to in the proposed approach is identified and addressed in the current modelling methodology of members. Such enforcement would not lead to any significant changes in the methodology of this member.

“EAD estimates must use a 12-month fixed horizon estimation approach.”

In general, it is not clear what is implied by this rule. Several institutions are currently using the PD estimation dataset as a starting point for EAD (CF) estimation - an account will be considered in the CF dataset as long as there’s an observed default event within any of the following 12 months.

Assuming that this new requirement is referring to the fact that the CF estimation dataset should contain those accounts which are not in default currently and will default in exactly 12 months, its enforcement will lead to a change of the current methodology and hence could trigger application for material changes. The proposed approach could generate more conservative estimates since the accounts included in the development sample would have more time available for withdrawing from their available limit. On the other hand, the considered development samples would exclude a significant part of the observations of accounts with history which is less than 12 months before the moment of default.

Conclusions

- The present draft regulation represents a significant turn in the regulatory agenda: for significant portfolios the risk sensitive internal approaches shall be replaced by in general one size fits all capital rules. Such a move in the existing view needs to be well understood in all its consequences, such as reduced incentives for accurate risk measurement, partly excessive risk taking, moving parts of lending towards the shadow bank system, increased lending cost e.g. for the commercial real estate sector. We believe that the time line proposed is by far not adequate to achieve that.
- The present draft regulation needs to be embedded in the wider scope of the regulatory agenda too: As one example we mention Expected Lifetime Loss provisioning under IFRS 9. For this purpose banks will have to run internal models also for those portfolios which would now be removed from IRB treatment. Those models would have an impact on capital accounts via portfolio provisioning. Regulators will have to take a view on the adequacy of such models in any case, so the effect of relieving the regulatory agenda would be short lived or even lead to further drifting apart of regulatory and accounting views.
- In the past years both industry and supervisors made significant investments in order to be able to estimate and validate prudent models on the side of the industry and to be able to verify the adequacy of such models on the side of supervisors. We believe that significant progress has been made in the past years - specifically also in the area of low default models - and that supervisory authorities have built up the capacity and the expertise to sufficiently reduce excess variation in risk weighted assets using the tools at hand. It is our understanding that efforts on the European level - the Targeted Review of Internal Models - aim to do precisely that: to harmonize supervisory and industry practice with the objective to remove excess variation in capital and along the way assure high quality risk

measurement within the industry. This could be opposed to the proposed short cut of removing some portfolios from IRB treatment.

- In this context we want to note that the Basel Committee assured the industry that capital requirements will not increase significantly.

Please give our concerns due consideration.

Yours sincerely,

Dr. Franz Rudorfer
Managing Director
Division Bank and Insurance