

**EAPB position paper on the Basel Committee for Banking Supervision Consultative Document
“Reducing variation in credit risk-weighted assets –
Constraints on the use of internal model approaches”**

24 June 2016

General remarks

The Basel Committee on Banking Supervision (BCBS) proposes to reduce variability in regulatory capital requirements for banks by constraining the use of internal ratings based approaches (IRB) in its consultative document published in March 2016. The European Association of Public Banks (EAPB) welcomes this initiative of the Basel Committee and would like to submit its position on the concrete proposals.

The main proposal in this regard is to remove the option to use IRBA for certain portfolios such as banks and large corporates or to significantly limit its use for other portfolios such as specialised lending. Furthermore, floors shall be prescribed for risk parameter estimation (PD and LGD). Last but not least, further requirements for parameter estimation shall also be elaborated.

The EAPB welcomes the aim of the BCBS to reduce variability in risk estimation. However, EAPB believes that this should begin with regulatory requirements for parameter estimation. In this regard, the BCBS should refer to the extensive work carried out by the European Banking Authority (EBA), which is currently working on harmonising minimum requirements for IRBA – notably the requirements for risk parameter estimation – across the EU.

EAPB would reject the suggested removal of IRBA for certain portfolios as this would lead to a dramatic reduction in risk sensitivity of regulatory capital requirements and could cause faulty signalling in banks as well as a destabilisation of the financial system. Furthermore, the disqualification of internal approaches would reduce the motivation of banks to use and further develop the advantages of advanced assessment procedures in risk management. EAPB is also concerned about the proposed limitations of applying IRBA in the case of securities firms. This would particularly affect institutions that use the advanced internal ratings based approach (A-IRB) and would thus be forced to revert back to the foundation internal ratings based (F-IRB) or standardised approaches.

Therefore, EAPB welcomes the Basel Committee's position that the finalisation of Basel III – also referred to as Basel IV – should not increase overall regulatory capital requirements for banks and highlights the importance that this should also hold for the new IRBA as well as for banks that currently use IRBA approaches.

The use of the standardised approach for large corporates and specialised lending obligors would, *ceteris paribus*, lead to a significant increase in capital requirements. This is derived from the fact that in many cases, risk weighting can only be used at 100% due to the often limited availability of external ratings. This would also affect small and medium-sized enterprises (SMEs) that qualify for corporates if they belong to consolidated groups with total assets exceeding 50bn EUR. For this reason, independent companies that have no direct legal or contractual liability to the parent company in terms of credit ratings should be treated as stand-alone companies when considering the removal of IRB. It is also important to ensure that the incentives derived from the use of IRBA to promote advanced risk assessment are maintained. This should also apply to the transition from F-IRB to A-IRB.

Taking the above into consideration, EAPB is particularly worried about the following proposals:

- Removing the IRB approaches for banks and other financials and impose a treatment under the standardized approach for credit risk
- Removing the IRB approaches for large corporates and impose a treatment under the standardized approach for credit risk
- Introduction of PD and LGD floors
- 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.

Given the material impact of these proposals on the risk weighted assets (RWAs) of EAPB member institutions and the unfavourable effects of losing risk sensitivity, EAPB hopes that the BCBS will revise the proposals. Therefore, EAPB would like to make suggestions on a possible revision of the BCBS proposals which will be further discussed under the second part of this paper (specific remarks).

Lastly, EAPB welcomes the fact that the Basel Committee plans to evaluate their proposals within the framework of a quantitative impact study (QIS). To ensure a better evaluation of the effects of the total calibration based on the QIS on different business models, it is urgently recommended that the entire package be put to a comprehensive consultation before it is approved.

Specific remarks

Scope for the use of internal ratings based approaches

The Basel Committee aims to limit the scope of IRBA approaches. In particular, IRBA shall no longer be accepted for the exposure of banks and large corporates. A (modified) standardised approach for credit risk shall be applied to these exposure categories in the future. With respect to specialised lending, it shall only be possible to use the so-called slotting approach within the framework of IRB. These exposures shall alternatively be determined by using the standardised approach. Furthermore, the A-IRB shall henceforth not be used to estimate CVA risks. EAPB would reject these proposals.

The limitations on IRBA in the mentioned areas would significantly decrease risk sensitivity with regards to regulatory capital requirements. The differentiation of regulatory capital according to the credit worthiness of clients is significantly less comprehensive in the standardised approach as compared to IRBA for rated banks and companies. The standardised approach has only four different base risk weights for rated banks and companies (including specialised lending) with the highest risk weight only rarely applicable to these clients. The standardised approach envisages only one risk weight each for non-rated clients and specialised lending without external rating. In this context, EAPB would like to point out that small banks and insurance companies generally do not have an external rating. Rating availability for large corporate clients is also lower than one would think. Furthermore, as the limiting criteria "total assets greater than 50bn EUR" must be applied at corporate level, many smaller and likely unrated companies that are part of a consolidated group would be subject to the standardised approach. This would imply that a big part of the corporate clients should be treated using the standardised approach for unrated corporates according to the BCBS proposals. Even in the so-called slotting approach in IRBA for specialised lending only a low level of differentiation of credit risk would prevail. As both, the standardised approach or the slotting approach would lead to a low differentiation of regulatory capital requirements as per true risk underlying the individual enterprises, EAPB believes that consistent bank management would no longer be possible. Economic and regulatory capital would diverge and banks would be forced to – at least as a secondary measure – also take regulatory capital requirements into consideration in their internally calculated economic capital arrangements. This could come along with increased risk of mismanagement and could affect credit extension. In addition, the problems linked to such as low level of risk differentiation would even be more significant against the background of the high exposure volume in the areas where IRBA should be removed.

In the future, especially in areas where no external ratings are available, high-risk and high-margin companies would have to be pooled with low-risk companies with the same

regulatory capital requirements. This would incentivise riskier undertakings and potentially cause negative effects on the stability of the financial system.

Moreover, from an internal risk management point of view, the proposed changes do not seem coherent. The most recent regulatory initiatives within the supervisory review and evaluation process (SREP) surcharges or Pillar I-plus approaches in the European Union resulted in IRBA playing a major role in internal management thus ascribing an implicitly higher importance to Pillar I. The congruence between regulatory requirements within Pillar I and the interest of internal risk management within Pillar II creates a clear incentive to design internal models in a fair and appropriate fashion. The proposed changes would however result in a weakened risk perception between Pillar I and II which could end up promoting the wrong aspects of internal management.

Furthermore, the removal of IRBA approaches to determine capital requirements in specific exposure classes with supervisory authorisation would weaken internal risk management in banks as this would substantially reduce the incentives for institutions to use and further develop advanced risk evaluation procedures. The internal rating procedures approved for IRBA entail models which were approved by supervisors and that have proved to be consistent throughout various controls. As a matter of fact, all changes linked to internal models must be communicated to the supervisory body and additional supervisory examinations must be carried out according to the scope and degree of the undertaken changes. In addition, the models are also examined once a year in the institution's internal revision which leads to very high quality standards in IRB.

EAPB believes that the pronounced use of IRBA models in banks is partly also linked to the supervisory authorisation that an IRBA model has to obtain before it can be applied. Since IRBA models are however also associated with high costs linked to their complex development and maintenance, a continuation of applying IRBA for internal purpose only seems not very likely once IRBA approaches in their current form would no longer be recognised. This holds particularly for the very laborious rating procedure for specialised lending. Experiences from other sectors have shown that data quality suffers significantly when the figures used for risk estimation do not directly affect regulatory capital provision and thus the determination of conditions.

The removal of IRBA to calculate capital requirements in Pillar I would be highly disproportionate, in particular if institutions would have to continue to carry out the analysis made with IRBA procedures for other aspects of banking supervision. In example, the proposals for calculation of regulatory capital for credit risks in the standardised approach intend for banks to not be allowed to mechanically adopt external credit ratings. Instead, in certain cases external ratings have to be verified internally with bank-own procedures. Also, for cases in which no external rating is available, internal procedures become essential for

the evaluation of credit worthiness. In addition, internal ratings are for some cases also requested in Pillar II.

The use of the standardised approach would mean that banks no longer use available information about the risks related to specific kinds of lending to measure regulatory capital. This would also be the case for the so-called slotting approach. Because of the rating criteria prescribed by supervisors, banks would leave out available knowledge about transaction specifications while estimating risk. The low risk differentiation afforded by the use of this approach would also be a huge step back in the risk assessment of specialised lending.

Last but not the least, there is a risk that banks would be ousted by other, less regulated capital investors in areas where IRBA can no longer be applied, simply because of regulatory capital costs that are disproportionate to risk. This would be detrimental to the stability of the financial system.

The proposals would also have a highly negative effect on banks that have specialised in lending to the exposure classes for which the BCBS is considering the removal of IRB. Even if regulatory capital requirements in these areas were to remain the same across all banks, it would still negatively affect banks that have specialised in low-risk ventures.

Variability of modelling results

The Basel Committee justifies its proposal to remove IRBA for the mentioned exposure classes due to the high variability resulting for the risk-weighted assets (RWA) of these exposures. However, studies carried out in this context have shown that most differences in average RWA between banks can be explained by the differences in undertaken risks. The BCBS is however of the opinion that around one-fourth of variation in the average RWA is linked to the different IRBA approaches applied by banks and authorised by supervisory authorities. In this context, the Basel Committee also concluded that institutions usually perceive the same relative riskiness when comparing clients and that the scope for variability rather arises from estimation of the general level of risk.

EAPB welcomes the BCBS intention to reduce the differences in capital requirements that cannot be explained by differences in risk. At the same time however, it has to be pointed out that IRBA modelling takes the individual characteristics of the institution into account and may thus also lead to systematic variability in results. EAPB therefore believes that this is intrinsic to modelling and that a complete removal of differences in estimation is not possible.

Furthermore, it shall also be highlighted that specialised lending was not included in supervisory benchmarking. In this regard at least, it remains questionable if the findings determined for corporate clients also match up to these exposures.

To reduce the recorded differences in risk estimation levels of institutions, the BCBS essentially proposes three measures:

- limiting the scope of IRBA
- introducing floors for capital requirements or the internally estimated risk parameters, and
- more accurate specifications for parameter estimation.

From among these measures, EAPB would believe that the proposal to introduce further useful and effective specifications for parameter estimation as standardisations is best-oriented to achieve the foreseen goal.

Further standardisation of certain model specifications is generally welcomed. However, it has to be underlined that an excessive standardisation would lead to all institutions using the same model assumptions and calculation methods, thus weakening the stability of the entire system. The complete removal of differences in estimation between banks is therefore not desirable. In fact, the first step should be to further harmonise supervisory requirements with IRBA procedures. This is especially applicable to the rules for estimating PD and LGD risk parameters. With their work programme published in the paper "Regulatory Review of the IRBA Approach" in February 2016, EBA embarked on a very promising path, which should be explored further. The ongoing review of IRBA models by the European Central Bank (TRIM) would contribute to this as well.

EAPB thinks that more harmonised legal specifications especially for the definition of default, with respect to data history and validation and also accompanying measures like supervisory benchmarking could achieve comparable levels of capital requirements and would thus be sufficient to reduce the differences in RWA that cannot be explained by differences in portfolio risk.

In case of limited data availability, the scope for banks' internal estimations of risk parameters could be reduced in order to avoid any arising doubts. Data pooling of different banks could be a solution to reduce such doubts further.

Modelling characteristics of portfolios

The Basel Committee also wishes to allow IRBA approaches only if banks

- have data that is both qualitatively and quantitatively sound,
- have an information advantage on other bodies (especially rating agencies), and
- use generally accepted modelling techniques which are capable of validation.

The first criterion (data availability) is quite understandable. Without a certain degree of data on defaults, reliable estimation of probability of default and LGD is not possible. However, this should not lead to it being impossible to use IRBA for portfolios with essentially low default rates. In fact, a greater effort should be made to outline minimum requirements for the necessary data on default together with banks. The use of IRBA in instances where it has been used to date should only be removed if not enough data is available according to these benchmarks. The existence of sufficient relevant data for internal modelling should be assessed at individual bank level.

However, even for partial portfolios for which sufficient data for risk parameter estimation is not available, risk weighting assessment methods could be introduced that are more risk-sensitive than the standardised approach and that at the same time, use the internally available information about the credit worthiness. In example, in such a case a slotting approach could be envisaged to assign risk weights in line with criteria prescribed by supervisors.

For specialised lending, the BCBS assumes that not sufficient data for reliable PD and LGD estimation would be available. However, EAPB believes that this is not the case. Specialised lending does not imply low default portfolios. Especially in the area of income-producing real estate (IPRE), it is possible to prove that sufficient data is available justifying the use of IRBA.

Rating procedures for specialised lending show in many areas an exceptionally high level of differentiation. This possibility to differentiate between clients with high and lower probability of default is confirmed on a regular basis whenever IRBA are validated by supervisors.

Furthermore, numerous institutions in the implicated areas use rating procedures that look at data compiled by multiple institutions when estimating risk parameters (so-called pool models). The number of defaults is hereby increased and estimations become more reliable. Therefore, EAPB would assume that the use of pooling solutions presents a suitable opportunity to tackle the BCBS concerns about data availability.

The second criterion (information advantage) is not convincing. Firstly, it is possible to conclude that banks in many areas, in which the BCBS is discussing the removal of IRBA, have better information than third parties. This is especially relevant for the area of specialised lending, where banks – unlike third parties – do not only have a very clear picture of project structures, but often also have significant intervention rights. Reports on market value and prognoses on payment streams are drawn up using lengthy processes to ensure the necessary objectivity and robustness of estimations. The estimation of PD and LGD for specialised lending is a real challenge and requires detailed object and lending-specific knowledge.

Regarding exposures to large corporates and banks, institutions would even have an information advantage over non-rated clients. This would be even the case for externally rated clients, as banks generally have better information about the payment behaviour of clients than, for example, an external rating agency.

Moreover, a less advantageous situation on data availability as compared to third parties is not a sufficient reason to prohibit the use of internal approaches. As with data requirements, banks should also work together in this context to develop minimum standards for necessary information that would allow rating procedures to continue being used.

In addition, the use of internal approaches allows banks to react quickly to a changing risk situation. If the financial situation of borrowers worsens, this would affect characteristics of certain rating criteria. An increased risk can then be identified by internal processes. Borrowers with high exposure values (large corporates and banks) would be closely monitored in this regard. The use of risk signals means that the worthiness of these clients would be earlier recognised by banks than by rating agencies. The rating process in the previous case would also be delayed due to differing objectives. Rating agencies weigh investors' need for information against possible self-reinforcing effects of early determination of worthiness. EAPB is therefore convinced that close monitoring of clients by institutions using an internal model would allow reacting much quicker to changing idiosyncratic risks enabling the banks to counteract immediately by increasing regulatory capital.

Furthermore, the third criterion (generally accepted modelling techniques) could have potentially adverse effects since the desired decrease in modelling variability would come along with the danger of more homogenous behaviours by banks during crisis situations, which can end up in worsening a crisis. This also reduces the possibility for banks to use different, competing models. As a result, competition loses its defining function of "incentive to innovate" in order to create superior solutions. At the same time, it would also make it more difficult for banks to achieve a competitive advantage by improving their rating procedure.

Internal rating procedures, therefore, are a method to estimate worthiness that is, at the very least, as good as methods used by external rating agencies and other market actors. The Basel Committee is correct to ask for a review of the standardised approach in a second public consultation, whereby banks are not allowed to only depend on the assessments of external rating agencies but must always carry out their own analyses as well. Last but not the least, there are clear advantages to internal rating procedures because, contrary to external ratings, they allow institutions to outline a comprehensive risk differentiation of their credit portfolio. The removal of IRBA for specific portfolios would mean that these advantages would no longer exist.



About EAPB

The European Association of Public Banks (EAPB) represents the interests of 32 public banks, funding agencies and associations of public banks throughout Europe, which together represent some 93 public financial institutions. The latter have a combined balance sheet total of about EUR 3,500 billion and represent about 190,000 employees, i.e. covering a European market share of approximately 15%.