German Banking Industry Committee

Die Deutsche Kreditwirtschaft

Comments

by the German Banking Industry Committee[1] on the European Banking Authority's draft RTS and ITS on benchmarking portfolios

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The **German Banking Industry Committee** is the joint committee operated by the central associations of the German banking industry. These associations are the Bundesverband der Deutschen Volksbanken und Raiffeisenbanken (BVR), for the cooperative banks, the Bundesverband deutscher Banken (BdB), for the private commercial banks, the Bundesverband Öffentlicher Banken Deutschlands (VÖB), for the public-sector banks, the Deutscher Sparkassen- und Giroverband (DSGV), for the savings banks finance group, and the Verband deutscher Pfandbriefbanken (vdp), for the Pfandbrief banks. Collectively, they represent more than 2,000 banks.

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I. General Comments

Any analysis of the root causes for differences between banks needs to factor in a number of methodological peculiarities: In the studies published to date, the EBA itself pointed out that banks' rating models differ in terms of the mapping to rating classes, the data sources (internal, external, hybrid), the type and nature of the use of historic data (length, weighting) the application of the floors, the definition of default as well as the calibration details (e.g. adjustment by means of the through-the-cycle or point-in-time-methodology, underlying master scales). This may result in different outcomes. Whilst not limited to, such differences may also result from different supervisory requirements under various national jurisdictions. At least if and when they demonstrably lead to significant RWA differences, such requirements should be standardised. Notwithstanding the foregoing, a full harmonisation is not advisable if it would give rise to high costs and if it would render the use of existing histories impossible.

Benchmarking forms part of the internal models' quantitative validation. However, the second material element consists in backtesting. In our understanding, there is an indispensable need for preserving the internal models' existing risk sensitivity; also, the benchmarking approach should not be used as a backdoor for the introduction of a compulsory uniformity. The most likely way of preventing the latter is if backtesting is generally given a higher priority than benchmarking. This should be applicable at least in the presence of methodologically flawless backtesting approaches (which does not apply to each and any internal approach) and it is applicable to cases where - also in the IRBA area - low default problems play no role. What must be avoided at this point is that - although backtesting does not suggest any need for action - corrections have to be carried out on the grounds of benchmarking concerns. The RTS should clarify beyond any doubt that, provided there is a sound reason, also larger RWA differences may potentially be legitimate and that these do not necessarily have to be levelled out. In light of the above, we are of the opinion that benchmarking for portfolios which lack backtesting options can be productive. In the presence of comparable markets and asset classes this would only offer value added for the other portfolios if risk sensitive benchmarks were established (e.g. by defining absolute deltas that ought to be deemed "normal"). However, from the present draft it does not become clear that benchmarking offers value added for portfolios with sufficient backtesting options.

Article 3 of the RTS says “[…] competent authorities may assess any other of the internal approaches of institutions […]“. From our point of view the entire Regulatory Technical Standard (RTS) is based on regulatory figures, i.e. Risk Weighted Assets (RWA). Thus, we assume that the RTS strictly refers to regulatory authorised figures and parameters.

Under Articles 8 to 12 of the RTS, the respective authorities are instructed to assess the internal approaches in a specific manner. Under the CRR, such rules already exist for all model categories. For example, the requirements which have to be fulfilled for a market risk model approval are already defined in Articles 365 to 377 of CRR, also differentiating between different risk categories and market risk models. Similarly, RTS Article 10(2) refers to information related to the aforementioned articles of CRR, again not differentiating between different risk categories and market risk models.

Due to the fact that the EBA does not have any authority to expand the Level 1 language, in our understanding the proposals made at this juncture are not of a binding nature but should be understood as recommendations; hence we suggest a corresponding clarification in the wordings. At this point, also the respective requirement's risk category should be taken into account (e.g. a rule on "name related basis risk" like the one under Art. 10(2) (l) shall only be relevant for market risk models which also cover the specific risk).

Benchmarking of the internal approaches for credit risks

More likely than not, in an ideal world featuring fully comprehensive information, banks would e.g. always assign the same PD to the respective borrower. In such an ideal world, the PD would be an initially unknown figure, the "true" level of which could be determined in an unambiguous manner. We hold the view that this is not the case and, particularly in the area of the PD and the LGD estimates, the reasons for bank-specific differences merit a closer review. At this point, there are objective reasons why e.g. two banks arrive at a different PD estimate and why it is not possible to blame either of the two for this. Both estimates may have a sound empirical foundation. In this regard, there is no objective "true level of risk". Yet, in the absence of the latter, it is hardly possible to make an assessment concerning a potential risk underestimation on the basis of a benchmarking approach.

First, with regard to the information gathering process in the lending business, it is worth noting that different banks will frequently arrive at different assessments of one and the same client. This may be due to different business models regarding the nature of the customer relationship. Soft fact risk drivers may have a significant impact upon the rating result. The more a bank invests into the customer relation, the better soft facts will lend themselves to the rating process. At this point, it becomes clear that - depending on the available level of prior information - different rating results on one and the same client may occur even in the event of identical rating systems. Instead of erroneously writing this off as the result of a good/poor benchmarking performance, any relative benchmarking concept has to recognise this difference.

Furthermore, it is worth highlighting that under the provisions of Article 179(1) lit. a) CRR, the less data a bank has, the more conservative it shall be in its estimation. In a market segment in which a number of banks only possess limited information, this will lead to a distortion of the relative benchmark; the benchmark is overly conservative. Banks that are able to draw upon comprehensive information could thus be seen as a bank which carries out outlier estimations featuring excessively low PDs. Hence, the regulation itself (which comes in the form of the CRR) becomes a driver in the outcomes' variability.
Please clarify in what level of detail feedback of the benchmarking results will be given to the participating banks. In particular, will banks receive the information on a counterparty by counterparty basis, where their internal rating for that specific counterparty ranks in relation the internal ratings of all other banks for that counterparty? (As is the case in the Millionenkredit-Meldung where the Bundesbank reports back to the banks the median PD of the counterparty over all internal ratings reported by banks.)

Benchmarking of the internal approaches for market risks

For the calculation and comparison of the Stressed VaR results, it might be necessary to provide a historical period which all participating banks have to apply (if possible). Otherwise each bank will apply its historical Stressed VaR period, which is determined by yielding the largest VaR for the bank’s current portfolio and might be different between the individual banks. This assumption is supported by the results of the Trading Book subgroup of the BCBS’ Standards Implementation Group (SIG-TB) showing that the use of different (weighting schemes applied to the) historical periods has a significant influence on the VaR results.
However, the EBA already recognises that it might cause major burdens for banks if they all had to perform the stress VaR calculation for a standardised stress period (p. 16 of the Consultation Paper). In this regard, we subscribe to the EBA's point of view. Not all banks have access to available market data

on each instrument during each and any stress period. Whilst not limited to, this caveat applies particularly to stress periods in the more distant past. Notwithstanding the above, standardising the stress period is still helpful from the point of view of a benchmarking exercise. Provided there is a sufficient transitional period and provided the stress period is jointly agreed with banks, we welcome such an implementation. In order to ensure the swift availability of data, we suggest initialising the stress periods beginning from 2008, at the earliest. Until the end of this grandfathering period, the EBA should bear in mind that major variability in stress VaR may already result from banks' diverging stress periods.

The CRR allows for a Partial Use of market risk models, i.e. using the internal market risk model only for some risk categories. This can distort the requested VaR results: Some products are relevant for several risk categories (e.g. currency swap: interest rate risk and foreign exchange risk), so maybe a reporting by risk category would provide more insight on the comparability of the modelled results.

Comments regarding the Consultation Paper specific questions

Questions regarding the RTS

Q1. Do you consider the use of common benchmarks for credit and market portfolios necessary to ensure a common approach?

From our point of view, the use of standard benchmarks for market risk and credit risks is unnecessary; we advocate in favour of a solution where the benchmarks shall be defined by national supervisory authorities. What is, however, far more important, is the fact that the benchmarks be appropriate for the respective model category and the portfolio under review.

Q2. Do you consider that the benchmarks outlined in the RTS are sufficiently proportionate and flexible? Do you have any alternative benchmark proposals? If yes, please provide details.

The "or“ link between the four benchmark criteria implies the need for a closer examination of the internal approaches for almost all portfolios in all banks. In our view, given the fact that the benchmarking approach produces only a limited amount of useful information, this is no longer sufficiently proportionate. Also, it is worth pointing out that - in the event of benchmarks which are not fit for purpose - any unusual outcomes shall and may not be used as an indicator for the appropriateness of a bank's risk assessment.

The proposed benchmarks feature major weaknesses; hence, as benchmarks, they are not fit for purpose. Good benchmarks need to fulfil a number of minimum criteria, among them (i) clarity of definition and uniqueness, and (ii) stability in time over several benchmarking cycles, at least.
RTS Art. 3 (2) a) (assessment of extreme values) violates criterion (i) unless the absolute maximum and minimum of the sample are implied by the term “extremes”. RTS Art. 3 (2) b) (first and fourth quartiles) violates criterion (ii) in that the same number of portfolios (resp. models, resp. banks) will be subject to increased scrutiny and specific supervisory assessment in every benchmarking cycle, no matter what changes were implemented by banks as a result of the preceding benchmarking cycles.

To solve these issues, we propose two changes to the RTS Art. 3 (2a) and (2b):

- RTS Art. 3(2) a): Replace the ill-defined term “extremes” by “outliers”. This term is defined in statistics, and there are easy operational procedures in descriptive statistics to detect evidence for outliers (cf. below). Moreover, we are convinced that an outlier – a data point a significant distance away from the body of a sample distribution – is a valid target for an assessment by supervisors, indeed.

- RTS Art. 3(2) b): Replace the metric of first and fourth quartiles by the metric of outliers as identified by box plots. A box plot will display stability in time when most of the changes induced by the benchmarking procedure are in the outlier portfolios but will adjust moderately when a large fraction of the portfolios evolve in time. Additionally, we would very much appreciate a definition of an "acceptable level of variance". Only variances beyond this acceptable level of variance should be examined further.

  Specifically, in the standard implementation of Box plots,
  - a uniform distribution displays no outliers,
  - a normal distribution displays rare outliers on both sides,
  - a symmetric fat-tailed distribution displays frequent outliers on both sides, and
  - a skewed distribution displays frequent outliers on one side only.

Most importantly, however, we believe that the metrics proposed in the RTS are inconsistent with Art. 78 (5) of the Directive 2013/36/EU, due to the fact that the proposed benchmarks indicate a putative need for action that is de facto unwarranted meaning that supervisory authorities are urged to take actions that lead to a standardisation of the approaches thus creating wrong incentives and triggering herd behaviour.

Q3. What limitations do you see in relation to the use of the proposed benchmarks, i.e., (i) first and the fourth quartiles; (ii) comparison between own funds under the internal models and the standardised approach; and (iii) comparison between estimates and outturns?

(i) first and the fourth quartiles
Under the current proposal, 50% of the internal approaches would automatically be conspicuous. In our view, this is neither meaningfulnor appropriate. Hence, we suggest using an outlier identification that is based on box plots (c.f. our above answer under Q2). At this juncture, the definition of an "acceptable level of variance" is important. One alternative "second-best" regulatory option the EBA might wish to consider is a reduction of the review scope resulting from changed quantile rules. From our point of view the use of the 90% and 10% quantiles is rather more productive for the mentioned purposes.

Implicitly, the approach is based on the working hypothesis that the median corresponds to the "true level of risk". However, this is by no means correct (c.f. our presentations under the section entitled General Comments).

(ii) comparison between own funds under the internal models and the standardised approach
The calculation of a standardised approach is a laborious and costly procedure and should be avoided. The reasons are manifold, but in particular that using the standardised approach as a benchmark presumes that it is related to the “true level of risk“. However, as it is a static measure it is not reacting to volatile markets, as – for example – the market risk models do. Moreover, banks using an approved market risk model for calculating RWAs usually do not have an implementation for calculating the standardised approach – and are not required to.

Furthermore, due to their insufficient risk sensitivity particularly in the credit risk area of the CRSA, standardised approaches cannot be regarded as an appropriate benchmark. More often than not, standardised approaches either underestimate or overestimate the actual risk. This, too, renders them inappropriate as benchmarks. Using standardised approaches as a benchmark during the variance analysis between the standardised approach and the internal approaches would merely illustrate the shortcomings of the standardised approaches. Due to their lack of risk sensitivity, the use of standardised approaches promotes herd behaviour and creates wrong incentives (i.e. incentives which are not risk sensitive).

Furthermore, for banks using internal approaches, an obligation is introduced through the "backdoor" to implement the standardised approach. This is inconsistent with the current CRR rules; as a result, the draft RTS exceed their legal mandate in an inappropriate manner. We have extremely strong reservations over this fact. Unless this benchmark is abandoned in light of the above caveats, we assume that the supervisor will either perform the RWA calculation using the standardised approaches or that the supervisor will outsource the latter to a provider of reporting software.

(iii) comparison between estimates and outturns
First of all, EBA has to ensure that all participating IRBA-institutes use the same definitions of default. Furthermore it is obvious that a modification of the consideration of collaterals would lead to a change in Loss Given Default. Failure to deal with those two issues would lead to distorted results.

Calculating the RWA on historical defaults and losses involves two problems:

- Low default rates in wholesale portfolios lead to the problem that quite a lot rating classes do not contain a default (depending on the size of portfolio).
  This is especially problematic for the better ratings classes. Consequently an aggregation of rating classes is necessary to receive reasonable results.
- To ensure a homogeneous determination of loss rates, there is a need for an EBA standard. Actually there is no specification given. Especially in the case of the one year horizon a determination of a realised loss is quite impossible because the duration of realisation is longer than the given horizon.

In our view, the use of "outturns" versus "estimates" gives rise to a host of methodological problems. For instance, already the number of the rating classes used in the IRBA might change the confidence intervals - and thus potentially a bank's conspicuousness. This may lead to wrong conclusions.

Q4. What in your view is the most appropriate benchmark and/or approach for the assessment of the level of potential underestimation of own funds requirements?

We suggest country specific peer group benchmarks.
For the IRBA, it may be helpful to use estimates offered by pool data operators as a benchmark. In Germany, there are several such providers.

Questions regarding the ITS

Q5. Which set of market risk portfolios do you consider more appropriate for the initial exercise conducted under Article 78?

The new EBA benchmark portfolio (annex VII a) seems to contain basic instruments to a larger extent than the TBG benchmark portfolio (Annex VII b), thus better representing the main drivers of RWAs in the banks’ real portfolios.

Furthermore, we would welcome a limitation to plain vanilla instruments. This enhances comparability given that not all banks are able (and, what is more, do not have to be able) to perform a valuation of e.g. double-no-touch options and variance swaps. However, according to Annex VII a, this exercise appears to be clearly more comprehensive than the comparative computation by the Trading Book Group. There is a need to calculate more instruments in more portfolios featuring a greater number of combinations which clearly drives up the operational costs (instrument setup, portfolio setup and portfolio statement, the first two of which are partly purely manual). As far as cost-benefit aspects are concerned, less is clearly more at this point (in the absence of any sacrifice in terms of added insights).

One major advantage in our view is the option of an analysis at the level of risk factors. Prior to the actual exercise, the test of the portfolios should be performed in close cooperation with the banks affected. This way, potential inconsistencies and misunderstandings can be addressed in advance. Also, a Q&A process should be established.

Q6. As explained in the background section, do you consider the approach proposed by the EBA appropriate for future annual exercises?

In our view, the benchmarking exercise's limited meaningfulness as well as the very limited added insights it offers fail to justify the proposed deployment of major resources by banks and supervisors. This equally applies to the IT resources required for the implementation of the annual reporting process.

Q7. Do you have any alternative proposals? If yes, please provide details.

First and foremost, the goal should consist in ensuring that the assessment criteria do not de facto lead to a situation where all banks are affected for all observed portfolios by the assessment. The EBA itself acknowledges that the fulfilment of the assessment criterion does not mean that the model estimates are faulty. Under such circumstances, however, in order to avoid major costs in the absence of any gain in added insight, the assessment criteria have to be selected particularly carefully. Hence we should like to issue the following recommendations:

- The assessment criterion "comparison to the standard approach" should be deleted (for a more detailed explanation cf. reply to Q3)
- The impact of the quartile-based assessment criterion should be mitigated by changed quantiles (e.g. 10%). Cf. also the answer to Q2 (box plots).

Q8. Which of the two options for phasing-in do you consider preferable?
We prefer option 2 featuring portfolio rotation.

Q9. Do you see any potential ambiguities in the credit risk portfolios defined in Annex I? Please identify the relevant portfolio providing details and any suggestions that would eliminate these ambiguities.

According to the definition of the clusters under Annex I/II C 103, the clusters for high default portfolios are inter alia formed on the basis of the so-called Indexed Loan To Value (ILTV). The ILTV is calculated on the basis of the current credit amount and the current market value. Yet, not all banks necessarily have access to the market value information. Under the provisions of the CRR, banks can either use the Market Value or the Loan to Value Ratio. On the basis of an EBA-RTS the latter is currently undergoing European wide standardisation.

Please confirm that the counterparties are to be understood as the legal entities. I.e. if ACME Inc. is listed as counterparty in the sample portfolio, the information requested refers to the legal entity ACME Inc. and not to any other entities / subsidiaries in the group of connected clients to which ACME Inc. belongs.

With regard to the report on the consolidated basis, clarification should be provided on how to report credit risk parameters which are not identical within the banking group. E.g., the same counterparty may have different ratings in different subsidiaries of the banking group or there may be different approaches to quantifying collateral haircuts in different subsidiaries. One possible approach would be to use the parameters of the group company with the largest exposure share for the sample portfolio. This might however result in a mismatch between the one specified PD and the overall reported RWA amount (calculated with the actual diverging PDs).

The portfolio of large corporates is defined as “annual turnover > EUR 200 mln”. Banks’ internal rating models for corporates are likely to have deviating turnover categories. I.e. one specific rating system may contain corporates with a turnover above as well as below EUR 200 mln. For data such as “default rate past 5 years” banks should be allowed to deliver this figure based on the turnover categories of their corporate rating systems, because it would be a laborious additional operating procedure to calculate a 5 year past default rate based on a portfolio definition that does not correspond to the banks’ internal corporate rating system categories.

Q 10. Do you have any suggestions for additional credit risk portfolios? Please provide details.

N/A

Q11. Do you see any potential ambiguities in the market risk portfolios defined in Annexes VII.a and VII.b? Please identify the relevant portfolio providing details and any suggestions that would eliminate these.

In Annex VII.a the descriptions of instruments 30 and 31 show discrepancies in their individual definitions in speaking about DKK/USD resp. SEK/USD forwards but in the explanation about "long DKK, short EUR" resp. "long USD, short EUR". In our opinion it should read "short DKK, long USD" resp. "short SEK, long USD" in correspondence to instrument 25.

Q12. Do you have any suggestions for additional market risk portfolios? Please provide details.

N/A

Q13 Do you agree with the possibility of allowing firms to refrain from reporting portfolios if one of the conditions stated in Article 3 is met?

We agree, but it should be clarified whether F-IRB banks would need to complete the information for LGD (and EAD and maturity). While F-IRB banks use supervisory values for these parameters, the LGD still has a bank-estimated component in the case of physical collateral. For physical collateral (e.g. real estate), the collateral value that feeds into the LGD calculation is determined by the bank.

Q14 Do you have any suggestion about additional exemptions from reporting? If yes, please provide details.

The aim of the benchmarking portfolio process is to gain insights on differences in banks’ RWA calculation. Thus, banks should only calculate risks for those products and risk categories for which they have regulatory model approval (and only these results should be used for the regulatory benchmarking). This also has the advantage that all risk models used for the benchmarking process have undergone the same stringent regulatory approval process thus guaranteeing the application of comparable standards. The results will then be less distorted by effects which are not in the scope of the benchmarking exercise.

Hence, banks featuring internal approaches which lack supervisory authorisation should be explicitly excluded from the benchmarking exercise. Missing authorisations have a considerable impact on the degree of divergence (this has been demonstrated e.g. by the results of the SIG-TB). Hence, they would render benchmarking approaches obsolete. Individual banks still lacked a supervisory authorisation for internal approaches concerning the additional default risks and migration risks in the so-called IRC portfolios. These banks considerably overestimate the risks; the latter only became possible given the missing use for the purposes of calculating capital charges.

Individual clusters may be immaterial for individual banks. In such cases, further exemptions should be possible. To this end, the EBA could stipulate a relative materiality threshold (e.g. 5% max. of the total RWA).

Comments on the options (cf. page 51f.)

Technical options for RTS
Market and credit risk – Options related to the assessment standards

In our opinion the "high level, principle based standards for NCAs" (option 1) are fit for purpose. We hold the view that certain standardisations and requirements are helpful (e.g. concerning the way in which backtesting/validation has to be carried out). More likely than not, such requirements will also lend themselves towards a reduction of the model results' variability.

Technical options for ITS
Credit risk – Options related to the scope of the portfolios

The expansion of the individual customer comparison to include hypothetical transactions (option 1c, 1d) cannot be operationalised in a meaningful manner. This is due to the fact that the amount of hypothetical profiles required in order to render a true and fair view of a retail portfolio is excessively high.

Credit risk – Options related to the list of counterparties for low default portfolios sample

In our mind, a list including all counterparties would be helpful (option 2a). In this context, we also advocate in favour of an unambiguous identification of the counterparties on the basis of the LEI. However, the list should not require an annual review by the EBA. At this point, a longer continuity would be more productive.

Credit risk – Options related to benchmark portfolios

We would prefer obtaining a complete portfolio list in the year 2014 (option 3b).

Market and credit risk – Options related to the level of implementation: consolidated and solo levels

We support the analysis both on a solo level but also on a consolidated level (option 1a).