Template for comments

Public consultation on the ECB guide to internal models – risk-type-specific chapters

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General comments


1. Credit Risk
2.2 Use of external data
34-35 16 Clarification

Generally speaking, the analyses requested in section 3.2 for the use of external data might not be sustainable, since they yield a level of disclosure close to the one available for internal data (for example representative analyses of paragraph 30). This disclosure level is usually not possible for data providers. In practice, these requirements, if met for the current formulation reported in the draft Guide, might lead to the impossibility of adopting external data (or at least the introduction of a material change of Conservatism not to be material for legal reasons and therefore illustrate that it is not an exceptional deviation but a "structural"

Inconsistency arises with the top down approach foreseen in (Bk/CB/2013/19) as the ability to allow institutions to calculate KIRB in accordance with the purchased receivables approach under Article 255 of CRR, in which the methodological approach will require pre-emptively on external data, given the impossibility to leverage on external being not representative of the scope of this model. It is important that the analyses requested by ECB guidelines might lead to the variability of the new risk assessment frameworks arising at measurements, as far Basel Committee standards, the supervisory pressure.

Classification is needed due to the difficulty of gathering information on external data providers data quality treatment.

2. Credit Risk
2.3 Use of purchased rating systems or models (pool models)
54(2) 10 Amendment

ABI would highlight that the section (c) (3) of the above concrence, including the definition of discretionary power and discretion power, should be applied only by itself in its own context. It stands in connection with Section 21 (3) (b) concerns. Indeed, in the case of a pooled model across legal entities, the same banking group (i.e. group-wide models), the pertinent of the engagement is to the group. Thus, it should be estimated in a more aggregated form (i.e. group-wide model). Moreover, the above approach would provide a partial (not necessarily precise) view. ABI proposes the following amendment of Box 2: "The paragraphs below are also relevant in cases where institutions use pooled data that are generated from institutions belonging to the same banking group, with exception of models developed and applied on an overall group level, so as to present in which the geographical location of the business is not relevant."

Updates requirement on group-wide models might not be consistent with group-wide nature of the models themselves.

3. Credit Risk
4.1 Structure of PD models
38-39 22-24 Clarification

With regard to the mapping approach, rating grades and the differentiation across rating grades of pool models, additional clarifications would be needed about the analysis to be performed in case of Low Default Portfolio (LDPs). Indeed, if the number of default events in a group is high, the results can be lead to inappropriate conclusions. Moreover, in order to obtain more robust results, banks could be incentivised to aggregate adjacent rating grades with potential problems arising in terms of accuracy or consistency of its results.

Additional clarifications would be needed about the analysis to be performed in case of Low Default Portfolio (LDPs).

Requirements on grade assignment dynamics seem not clear.

4. Credit Risk
4.1 Structure of PD models
61 24 Clarification

It is not clear the meaning of "including drivers that are predictive over a longer time horizon" as requested by paragraph 4) and how the 20 year horizon indicated in it should be embedded in the modeling frameworks.

Requirements on grade assignment dynamics seem not clear.

4. Credit Risk
4.2 PD risk quantification
65-66 32 Clarification

Some clarifications should be provided about the mapping between internal and external ratings. Indeed, the following aspects should be considered:
- no full disclosure is available about the criteria used by the external organizations;
- the use of "short term obligations" could be very small, smaller or equal to 10% of the external rating scales, faster or slow to be embedded in the modeling frameworks.

Some clarifications should be provided about the mapping between internal and external ratings.

5. Credit Risk
5.1 Revised LGD
6 27-38 Amendment

The LGD computation at facility level is a general principle that can be shared. Nevertheless, there can be some cases where a more aggregated computation is necessary not only due to a material intrinsic recovery process but also for the few effects of the cash flows receded. This is in particular the case of Small and Medium enterprises which are not subject to a capital account and thus to the capital adequacy requirements. However, in such cases, a separate computation for these cases would result in an incorrect economic treatment. An alternative approach is the one foreseen in the draft Guide for risk adjustments. In this way, for the few cases where the LGD computation at facility level is not based on an aggregated computation but on an aggregated approach, the LGD computation at facility level is a general principle that can be shared. Nevertheless, there can be some cases where a more aggregated computation is necessary.
It should be clarified that the restructuring involves only previously defaulted facilities or cases where the measures adopted determine the default of the customer and non-commercial practices were taking place in the contractual conditions without classifying the client as a default. For example, in the negotiation of the interest rate in a restructuring, customer does not determine automatically the default and therefore must be out of the scope of this Article. Given this premise, the following paragraph “Where institutions open new facilities to replace previously defaulted facilities as part of restructuring or for technical reasons, the restructured loan should be classified in the degree of impairment in terms of exposure-weighted average LGD at the obligor level and then take the arithmetic average LGD weighted by the share of each obligor in the exposure. The first approach would be consistent with the calculation of LGD only after the repossession, as defined also within the EBA GL on PD and LGD” is not clearly defined if multiple default treatment in PD model should consider independence period as LGD model. This is not a fully consistent across the guidelines.

The LGD structure (105) 42-45 Deletion

The model component approach is designed to capture different aspects of the recovery process and allows to obtain LGD models which in general can assess distinct dynamics of LGD within different classes and between default and non-default. The request to demonstrate independence among the components seems not clear and not coherent with other regulatory prescriptions. The goal of the model components is different and also the drivers of the LGD components are different even in the case of LGD structure. The independence period of LGD structure should be out of the scope of this Article. The request to demonstrate independence among the components seems not clear and not coherent with other regulatory prescriptions.

2 Credit Risk 5.3 Risk quantification 111 46 Deletion

A coherent approach should be adopted between LGD and CCF on the additional drawings.

1 Credit Risk 5.1 Realised LGD 100(b) 39-40 Clarification

Clarification would be needed about how the pro-forma correction has to be applied on the historical series. It should be clearly underlined that a coherent approach has to be adopted between LGD and CCF on the additional drawings. A coherent approach has to be adopted between LGD and CCF on the additional drawings.

1 Credit Risk 5.1 Realised LGD 100 39 Amendment

The analyses required on independence period appropriateness, based on analysis related to the curing process, are basically consistent with the analyses and conclusions between 2012 (paragraph 3) on which the independence period should be applied, within the EBA GL on Definition of Default (EBA/GLD.0097-17 paragraph 76). Therefore, in ABI’s opinion requiring further analyses on this, considering also the critical and questionable requirements treatment introduced by independence period (i.e. relevant for LGD but not for PD), result in a lower value added when compared to the previous approach.

1 Credit Risk 5.1 Realised LGD 100(b) 40-41 Clarification

From historical data when institutions have not adopted the minimum 3-month probability period on downsized restructured facilities under paragraph 17 of the EBA GL on the definition of default, they should consider a 21-month period for the application of paragraph 15 of the EBA GL on PD and LGD. The 12-month probability period is a necessary requirement for the definition of the default. The determination of forbearance period is quite complex and depends on the specific case. For this reason, the LGD structure should be tailored according to the LGD model. The LGD model should be validated against the LGD structure.

1 Credit Risk 5.1 Realised LGD 98 39 Amendment

Amendment would be needed about how the pro-forma correction has to be applied on the historical series. Thus, it is not a clearly defined if multiple default treatment in PD model should consider independence period as LGD model. This could lead to a bias on the calculation of the expected losses as well as the number of defaults is not fully consistent across the guidelines.

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The proposed treatment of outliers in statistical distributions is technically between the two tails. The one hand paragraph 113 (b) requires to base the LRA DR on one or more fixed horizon approach (e.g. observed of LGD) on the basis of the average realised facilities rather than adopting aggregations valid on LGD side. This approach would suggest to amend the wording making reference to possible aggregation according to the characteristics of the facilities rather than relying on observations available on LGD side.

The request to demonstrate independence among the components seems to be not very clear neither coherent with other regulatory prescriptions. It should therefore suggest that the burden of proof for institutions is to provide empirical evidence of the independence be defined in this approach.

Clarification on how to interpret this issue and for more details on the approach to be applied. All highlights that an important move in it is avoid as much as possible the excessive variability in the RWAs and therefore the correction to be applied should be based on an adequately PIT logic.

As long as the EBA RTD 45 and 46 on downturn will not be closed and considering the strong debate on this on several critical points (e.g. adoption of the Reference Value, this section should be, for the time being, removed from the current version of this Guide).

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A broader explanation for what "expected" stands for would be needed. ABI highlights that an incentive to use totally PIT rating systems in order to minimize variability of default rates for each class. On the other hand, this would increase RWA variability. It should therefore suggest that the burden of proof for institutions is to provide empirical evidence of the independence be defined in this approach.

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Credit Risk 3.6 Review of estimates 46 52 Clarification The list of instruments that are presumed to be held for trading purposes and that should be classified within the regulatory trading book has been slightly amended compared to the CRR I version regarding the activity in funds. There is no mention of the equity investment in funds in the Trading book list (paragraph 7.7 of the follow-up chapter). Consequently, the Banking Book list includes the "equity investments in a fund for which the investment capital is liquidizable only in the context of operational liquidation. The reference to a daily frequency has been removed. Does it mean that the ECB considers that funds with equity investment only can be classified within the Trading Book?

Market Risk 2.2 Delimitation of the regulatory trading book 6 68 Clarification The paragraph expects to harmonize the standards of the internal policies describing the FX Position consolidation process, in the absence of a sufficiently detailed regulation on how the consolidation should be carried out for the purpose of the calculation of OIS participation of FX positions. Harmonization should begin from as the consolidation principle in the first place.

Market Risk 2.1 Treatment of off-balance positions 15 73 Clarification The draft Guide could be subject to divergent interpretations and needs to be clarified.

Credit Risk 8 Review of estimates 146 63 Clarification In case of "in scope" of market risk refers to adjustments that help capturing the actual dynamics of market variables, then paragraph 2 of Article 2 of CRR I appears undue. It is difficult to see how an adjustment that helps capturing variations of the risk factors, and thus of the market risk, should be excluded from the scope of the paragraph.

Market Risk 5.5 Proxies, beta approximation and validation 49 69 Clarification The paragraphs refer to the validation of internal models and the use of hypothetical portfolios. The paragraph expects to harmonize the standards of the internal policies describing the FX Position consolidation process, in the absence of a sufficiently detailed regulation on how the consolidation should be carried out for the purpose of the calculation of OIS participation of FX positions. Harmonization should begin from as the consolidation principle in the first place.

Market Risk 5.7 Pricing functions and methods in the model 134 109 Clarification The concept of "observable data" is not set in CRR. FRTB contents should not be front-loaded. ABI, Association Italian Banking Association - Associazione Bancaria Italiana (Italian Banking Association)
Clause 6.5—Ratings, probabilities of default and recovery rate assumptions

The paragraph suggests that a two-year constant position assumption does not require, by itself, to be justified in terms of adequacy. The paragraph requires an equally weighted average PD of those issuers not subject to an unweighted approach. An unweighted average could not be representative of the portfolio, and in addition, given the statistical.rescaled standard, an unweighted PD would not dominate. Therefore, ABI suggests applying a weighting mechanism (JtD or Incremental Blend). This is for those risks within the current engine, nor their impact on the Bank VaR (SVaR). For instance, if the factor is not directly observable or it is an illiquid position the incremental risk number might not be easily measured. Furthermore, there is no clear indication in the CCR that an extension of IMA to a RNIME is required. RNIM can be handled in the scope of existing IIA (v.a. v.t. and CRR) through dedicated add-ons where all price risks might not be fully represented in the model.

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The paragraph suggests that Article 367 rules generally risk engines and that RNIME can be included in such category meaning no incorporation of the risk. For the other risks, CRR explicitly mentions the (S)VaR, IRC and CRR as RNME regimes not mentioning anything about Basel 3 or even longer decay of impact by expressing in 376 (1) that a small FSA cannot assume anything about price risks. The silence of the Guide seems hence over-reaching in requiring RNIME to have the same standing of a component of the Pillar 2 capital against model risk. ABI therefore suggests reverting to the 2017 concept of Basel excluding any extension of the current IMA parameter. RNIM should be strictly complementary adding the exiting Market Value models with on-off add-ons to address material outcomes in the quantification of the price risks.

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lack of diversification benefit and simultaneous calculation of RNIM impacts would lead to over-estimation of the relevance of such risks, once embedded in the models, might well produce unrealistic and risk metrics.

In conclusion, if such a quantification system gives rise to capital strain (as opposed to simply triggering model enhancement) for those cases where back-testing exceptions are also included in the model deficiency, there will be a double counting of capital requirements.

The previous considerations are relevant in the case of a RNIM cumulated impact higher than the 10% threshold (185): the supervisory action plan by the ECB is to issue one or more RNIMs or the determination of the appropriate risk impact for the effective reduction of the impact of the unforeseen measure in an institution’s risk engines. The same mechanism is not triggered in all scenarios, and as a consequence, the impact at the same confidence level is the reference risk number. As a consequence, one may rely on a stress testing level based on expert judgment (as mentioned in item (16)) that will be expected and more conservative than a stress testing level based on (99.9% quantile) of 30 days holding period. If the 99.9% quantile over a one-tailed test (99% quantile) the individual stress tests are built to be more adverse than that, then assuming that all happen at the same time is an even more remote scenario. Finally, the absence of diversification creates a great adverse between the two measures taken as a reference (since risk factors included in the model benefits diversification effects and the cumulative effect of all RNIMs).

The quantification approach appears overall conservative and is liable to generate capital add-ons in excess of what the validation function is supposed to do. It is highly arguable that the 5% and 10% threshold ratios of the EBA RTS on model change materiality however they refer to a quantity that does not show the same characteristics as an IMA.

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The CRD defines the exposure in terms of market value of the derivatives and availability of eligible financial collateral. The request to cease into account the unpaid collateral during the margin period of risk (MPOR) would imply an additive treatment of the exposure. The CRD seems not to contain any references to the need that the exposure should encompass also such cashflows. The CRD documents of the TRIM guide regarding the consideration of unpaid trade-related cashflows (CFs) as part of the exposure do not indicate any reference to the need that the exposure should encompass also such cashflows.

Paragraph 68 states that institutions should ensure a comprehensive coverage of their back-testing framework by selecting back-testing coverage rates at least at the risk factor level. In this respect, a definition of "this factor" would be helpful. Paragraph 68 seems not very clear and consistent in some aspects. The paragraph refers to the cases where guarantees parts of the validation framework e.g. back-testing are conducted by model developers and aims to define, under which constraints such an approach is deemed compliant with the requirements in Article 280(1) of the CRR (in independent review). The reference to "operational parts" only implies that the methodological part underlying the operational part should be designated by model validation function. On the other hand, paragraph 68(b) describes a "rigorous operational validation procedure" stating that such methodological aspects should be designated by the model development function, which seems not consistent.

The requirement in §68(a) that "the validation task is conducted on behalf of the validation function" can be not consistent. In other words, a regular, independent and effective assessment of the validation function is required. Paragraph 68(a) may be interpreted at different ways and is not clear that how this could be implemented organizationally. Finally, the requirement in §68(a) implies that the model validation function should have the judgement of the outcomes of the analysis and "respective remedial measures". This requirement takes into the view that ongoing model performance and monitoring (such as back testing or pricing comparisons) are exclusively part of model validation and fails to address the facts that, while being irreplaceable parts of validation, they are other parts of model maintenance and model risk management process. Besides, the requirements in §68(a) that "the validation task is conducted on behalf of the validation function" can be not consistent.

The request to take into account the unpaid cashflows during the margin period of risk (MPOR) would imply an additive treatment of the exposure. The CRD seems not to contain any references to the need that the exposure should encompass also such cashflows.

The CRD does not explicitly mention trade-related CFs. The request to take into account the unpaid cashflows during the margin period of risk (MPOR) would imply an additive treatment of the exposure. The CRD seems not to contain any references to the need that the exposure should encompass also such cashflows.
ABI would seek confirmation that it is deemed reasonable to assume a validation cycle of the pricing functions that
does not only rely on analyses directly performed by the Internal Validation but also on activities performed by members
of the Risk Management unit and supervised by Internal Validation, as reported in paragraph 86.

As cited in previous comments, the inclusion of back-testing of actual portfolios seems not to be mandatory pursuant to
CRR art 294(1). That said, it would be useful to better explain what is intended by “consistency”: it may refer to portfolio
consistency across transactions or across netting sets but also to model consistency, pricing function consistency, instrument mapping consistency and/or market data consistency.

With regard to portfolio consistency, a lot of technical issues may arise in case of close-out transactions: all the
predictions for the horizons after the close-out transaction date must be reperformed based on the new netting set
without those close-out transactions. This may lead to storage limitations: it is not feasible to store all the Monte Carlo
scenarios at transaction level, for each close-out transaction, for each prediction date. In addition, it is not possible to
quantify the amount of collateral to be exchanged in case of portfolios made of rolling instruments.

The effort requested in order to keep consistency (any of the previous) between predictions and realizations within
the actual back-testing seems disproportionate.

Explanation about how the exposure measure is defined would be needed. In case of the exposure defined as in Article
272(4), it would be helpful to explain how to treat possible forecast distributions all equal to zero: i.e. when the
expected values (collateralized or not) are all negative. This also applies to the 97% or 99% risk measures. In ABI’s view, the best way to test the prediction model is to use the whole distribution of positive and negative
exposure, defined as the difference between the MTM and Collateral. In the case of unmargined netting sets, the
collateral is zero.

A more precise definition of what is intended for “separate validation” of the margining process would also be useful.

ABI would seek confirmation that it is considered an acceptable interpretation that the exercises requested in paragraph
79 should be performed at hypothetical level only, e.g. isolating sample trades and back testing their behavior.