Template for comments

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

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<td><a href="mailto:gjones@isda.org">gjones@isda.org</a></td>
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☐ Please tick here if you do not wish your personal data to be published.

General comments

Contact details related to each chapter

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<tr>
<th>Comment ID</th>
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<th>Factual content</th>
<th>Possible clarifications or proposed amendments</th>
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It would be most welcome to clarify whether applying this provision is necessary given that no mention of it is made in the BCBS “Basel III: Finalising post-crisis reforms.”

It should be clearly underlined that a coherent approach has to be adopted between LGD and CCF on the additional drawings in case the LGD is impacted by additional credits. In particular, if the customer is considered as having a high likelihood of default, the additional drawings may result in a higher LGD. Therefore, it is suggested to replace the term “exceptional situation” with “justified situation” and add in the subsequent bullet point the following sentence: “provide evidence that recovery at facility level would be biased due to the mixed effects recorded across different facilities.”

It is suggested to replace the term “non-observed default” with “non-default default” and review the calculation of the CCF for facilities in case of non-observed defaults. For example, the renegotiation of the interest rate with a Performing customer does not determine any credit deterioration of the facility. Therefore, the renegotiation of the interest rate with a Performing customer should not be considered in the calculation of the observed average LGD (with a maximum period equal to 12 months). This principle is correct but should be specified as well for institutions applying a model component approach: in this case the credit deterioration due to the entrance in default but as well from the entrance in the litigation process. In fact, in a standard approach the LGD is calculated as the present value of expected losses. As a result, changes in contractual conditions are not reflected in a cash flow but are related to a financial concept which is in fact a “structural” practice. For this reason, it is suggested to replace the term “justified situation” with “structural” practice.

In order to harmonize the treatment of these cases, it is suggested to amend the Article to remove the risk of misinterpreting the LGD of a facility or a portfolio. In particular, it is suggested to replace the term “structural” practice with “dilution” and to add the following bullet point: “the amount by which the financial obligation has diminished (e.g. from a reduction in an interest rate, a reduction of the loan amount or a postponement of payment of principal, interest, or fees). The amount by which the financial obligation has diminished should be calculated under paragraph 51 of the EBA GL on the definition of default.”

The proposed amendment to the Article also takes into account the current bibliography and the recent publications on this subject. For example, the recent paper by Jones (2018) on the calculation of the LGD provides useful insights on this topic. Therefore, it is suggested to replace the term “dilution” with “Jones, Gregg, 2018” and add the following bullet point: “the amount by which the financial obligation has diminished should be calculated under paragraph 51 of the EBA GL on the definition of default.”

It should be clarified how economic loss should be calculated in the case of facilities that return to a non-default status after having missed some payments. In particular, the following sentence should be added: “the bank can demonstrate that, whenever a facility returns to non-default status after having missed some payments, the LGD must be calculated as the difference between the expected LGD and the LGD that would have been calculated at the entrance in default but as well from the entrance in the litigation process. In fact, in a standard approach the LGD is calculated as the present value of expected losses. As a result, changes in contractual conditions are not reflected in a cash flow but are related to a financial concept which is in fact a “structural” practice. Therefore, the renegotiation of the interest rate with a Performing customer should not be considered in the calculation of the observed average LGD (with a maximum period equal to 12 months). This principle is correct but should be specified as well for institutions applying a model component approach: in this case the credit deterioration due to the entrance in default but as well from the entrance in the litigation process. In fact, in a standard approach the LGD is calculated as the present value of expected losses. As a result, changes in contractual conditions are not reflected in a cash flow but are related to a financial concept which is in fact a “structural” practice. For this reason, it is suggested to replace the term “justified situation” with “structural” practice.”

Overall, the requirements are deemed overly conservative. In particular, bullet point (f) should be deleted. The following sentence should be added: “the amount by which the financial obligation has diminished should be calculated under paragraph 51 of the EBA GL on the definition of default.”

Where institutions include additional drawings after the moment of default to estimate CCFs, these additional drawings are added to the outstanding amount at default in the denominator (paragraphs 139-142 of the EBA GL on PD and LGD). In order to ensure consistency, it is suggested to replace the term “justified situation” with “structural” practice. The following sentence should be added: “the amount by which the financial obligation has diminished should be calculated under paragraph 51 of the EBA GL on the definition of default.”

It is suggested to replace the term “non-observed default” with “non-default default” and review the calculation of the CCF for facilities in case of non-observed defaults. For example, the renegotiation of the interest rate with a Performing customer does not determine any credit deterioration of the facility. Therefore, the renegotiation of the interest rate with a Performing customer should not be considered in the calculation of the observed average LGD (with a maximum period equal to 12 months). This principle is correct but should be specified as well for institutions applying a model component approach: in this case the credit deterioration due to the entrance in default but as well from the entrance in the litigation process. In fact, in a standard approach the LGD is calculated as the present value of expected losses. As a result, changes in contractual conditions are not reflected in a cash flow but are related to a financial concept which is in fact a “structural” practice. Therefore, the renegotiation of the interest rate with a Performing customer should not be considered in the calculation of the observed average LGD (with a maximum period equal to 12 months). This principle is correct but should be specified as well for institutions applying a model component approach: in this case the credit deterioration due to the entrance in default but as well from the entrance in the litigation process. In fact, in a standard approach the LGD is calculated as the present value of expected losses. As a result, changes in contractual conditions are not reflected in a cash flow but are related to a financial concept which is in fact a “structural” practice. Therefore, the renegotiation of the interest rate with a Performing customer should not be considered in the calculation of the observed average LGD (with a maximum period equal to 12 months).
5.4 Estimation of ELBE and LGD in-default

We suggest to delete items (a) and (b).

49-50

5.3 Risk quantification

136(c.)

ISDA and

Clarification is requested between fixed horizon approach and cohort approach: Basel Committee on Banking Supervision has indicated that in the framework of its second cycle of inspections the cohort approach is the preferred one, while, both in inspections and in this Guide, the cohort approach is

Refer to amendment to paragraph 97(a) on LGD.

46-47

124

Bearing in mind what underlined for LGD computation about paragraph 96, we think that an amendment is necessary for CCF computation approach is not always coherent with the LGD one since the analysis of the effects has to be performed

ISDA and

5.3 Risk quantification

113

ISDA and

134(b)

113(a)

5.3 Risk quantification

Clarification

115(b), (c.)

Clarification

"The ECB should modify this paragraph with regards to the final version of the "EBA Guidelines for the estimation of LGD appropriate for an"

136(b)

Under the assumption that the distribution of facilities per obligor is quite homogeneous, leading to similar results

ISDA and

46

institutions shall estimate conversion factors by facility grade or pool on the basis of the average realised

ISDA and

46-47

55

institutions shall estimate conversion factors by facility grade or pool using the default weighted average resulting from all observed defaults within the data sources).

cap is a more appropriate alternative than the uncapped realised CCF value. As per paragraph 113 - c about LGD, we deem the risk of the right tail of the distribution inappropriate. An appropriate treatment (i.e. interquartile range) has to be performed in

ISDA and

5.3 Risk quantification

5.3 Risk quantification

132

institutions should be able to demonstrate why and how

ISDA and

5.3 Risk quantification

The drivers tested are, in general, different; the burden of proof for institutions to provide empirical evidence of their independence has to be deleted from the document.

cure/migrations within default statuses and between default and non-default. The request to demonstrate independence according to a logic coherent with the dynamics of the drawn and undrawn amounts. First of all a separation is necessary to

ISDA and

5.3 Risk quantification

5.3 Risk quantification

50

geographies.

geographies.

"The RTS on IRB assessment methodology leaves the possibility to model LGD-in-default or UL. We consider that any downturn conditions should be taken into account in the LGD-in-

AFME

Publish

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Credit Risk

ISDA and CCF risk quantification

The list of instruments that are presumed to be held for trading purposes and that should be classified within the CCF list includes a specific group of assets (e.g. in the case of CCF calculation of a CCF in the following situations): For the sake of clarity, the list should be updated with the latest amendments to the ISDA guidelines.

Amendment

2.5 Exclusion of positions in the regulatory book list

Deletion

The risk of an excessive operational burden is also linked to the request of model review every three years (or more) and the need to constantly update the model inputs. Hence, the request to consider each year's variability might produce the following effects (in particular for LDP):

- potential contradiction with the necessity to cover "likely variability of the default rates".
- increasing the number of parameters to be estimated and, consequently, the number of observations necessary to accurately estimate the default rates.
- increasing the computational complexity and the model's sensitivity to input changes.

Furthermore, the request to consider each year's variability might produce the following effects (in particular for LDP):

- increasing the number of parameters to be estimated and, consequently, the number of observations necessary to accurately estimate the default rates.
- increasing the computational complexity and the model's sensitivity to input changes.

Deletion

In particular, we wish to underline that CCF are out of the scope of EBA works on Downturn topic, given the forthcoming changes to the Basel III framework, and thus we deem it inappropriate to derive specific requirements for LGD on CCF.

Amendment

Clarification

Model-related MoC

The requirement to estimate the statistical uncertainty/sampling error stemming from the variability of each year's default rate might produce the following effects (in particular for LDP):

- increasing the computational complexity and the model's sensitivity to input changes.
- increasing the number of parameters to be estimated and, consequently, the number of observations necessary to accurately estimate the default rates.

Deletion

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Amendment

Deletion

Clarification

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Amendment

Clarification

Deletion

Clarification

Amendment

Clarification

Amendment

Deletion

Clarification
3.7 Analysis of overshootings

Requirements operationally complex which may not add significant value.

Amendment

The industry has concerns with this section—especially paragraph 169 relating to modelling groups of connected clients and issuer concentrations which exceeds Article 376.3b:

139

Jones, Gregg

Clarification

The list of risks listed as giving rise to RNIME is very broad and includes items (e.g. IRC factor model assumptions) ... of day to day risk monitoring activities designed to ensure that any material price risks not captured are identified.

There is a contradiction between paragraph 170 stating that IMA model components consist of an “engine” plus RNIMEs, and paragraph 171(b) excluding RNIMEs from regulatory back-testing, for capital multiplier purposes in particular.

118

The article’s (paragraph 128) requirements seem to front run elements of the FRTB, specifically the P&L attribution ... appropriate to front run these elements through the draft ECB text, in advance of the FRTB finalization. This will impose new requirements on banks and bring forward staff resource.

5.2 General requirements

111

AFME

Publish

7.2 The framework for risks not in the model

114

AFME

Publish

81,82

AFME

Publish

90

AFME

Publish

In particular, the paragraph requires a test where two types of P&L

Differences in pricing functions between the VaR engine and the actual and hypothetical P&L calculation (the front-office pricing functions)

As such the language in the article should be amended to require analysis on the elements which are caused solely by the actual P&L – i.e. the difference between actual and hypothetical P&Ls. We recommend that the ECB allow for the capital release to be derived from the

In particular, the paragraph requires a test where two types of P&L

Requirements related to the granularity of P&L explain should be deferred to align with the FRTB timeline.


differences related to market risk capital via alternative means for example the IRC model or RNIMEs. We recommend that the ECB allow... overshootings related to market movements driven by event risks that are alternatively captured in the own funds model.
The new version of the ECB guide does not allow for diversification benefit between RNIMEs, whereas the previous version ... regards to RNIME calculation: "(…) the bank should propose a remediation plan or show that the effect is not material or else the bank's RNIME calculation is not acceptable."

• Allow a diversified assessment of risks, where a diversified calculation can be methodologically justified;

At present, the formula implies (via the term 'incorporated') that an institution has to actually incorporate the risk factor into the risk engine calculations. This is an important point that needs to be clarified. If this point is not addressed, it will leading to an important increase in the number of RNIMEs, which will be detrimental to the model approval process. This could also result in a significant number of model approvals that will be short-lived or not-lived at all.

• Allow the bank to account for material differences only in the context of a remediation plan. The industry strongly requests that a clarification is added, stating that use of appropriate estimations of marginal impact is acceptable.

The new version of the ECB guide has significant potential to lead to bottlenecks in the model change approval process. This could set an adverse incentive not to include RNIMEs until it is absolutely necessary. Considering RNIME as part of IMA seems to set a higher bar than out reaching the CRR prescriptions around the subject. Additionally having RNIME subject to the RTS on model changes and extensions (see the feedback to paragraph 173) creates a further layer of complexity.

The interaction mechanism with FRTB come into force is also very unclear and exposes to the risk of confusion and potential non-compliance. It is important that the industry is given clarity on this matter as soon as possible.
Counterparty

Current paragraph should be reworded as follows (addition in square brackets):

- Jones, Gregg

Clarification

142-

Replace in 23 (a) :

- Jones, Gregg

Amendment

ISDA and

Jones, Gregg

143

"The rescaling would lead to a significant deviation of the CCR and exposure metrics compared to the actual risks in institutions practice and therefore not consistent with the actual counterparty credit risk (b) In order to obtain the alpha increase, the add-on of paragraph 24(a) would be added to the EEPE for each netting set and the overall increased exposure would be compared with the overall exposure using only the EEPE (see Annex 1)."


- Jones, Gregg

Amendment

The rescaling would lead to a significant deviation of the CCR and exposure metrics compared to the actual risks in institutions practice and therefore not consistent with the actual counterparty credit risk (b) In order to obtain the alpha increase, the add-on of paragraph 24(a) would be added to the EEPE for each netting set and the overall increased exposure would be compared with the overall exposure using only the EEPE (see Annex 1)."


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The following sentence should be added (in "clarification") to the paragraph "...of IMM pricing functions, are conducted by staff also responsible for model design and development, the above-mentioned burdensome assessment process the manual review steps for a recalibration should be limited. In addition, please note that the current calibration frequency as part of its back testing program as is required by Article 293(1)(c) of the CRR.

Furthermore, a significant change in Article 292 as it sets the calibration frequency to monthly and replaces the need to assess the effectiveness of the model on a quarterly basis. Moreover, it can be argued that a monthly recalibration based on market implied volatility would provide a more accurate and consistent representation of the risk.

As a Monte Carlo error of 5% is tolerated (paragraph 56) then simply changing the density of the grid could have an impact on the accuracy of the profile.

Adding these approaches could avoid a necessary reliance on collateral eligibility schedules which are burdensome to capture in IT systems and which are difficult to assess in terms of the most likely collateral to receive.

In order to comply with the requirements laid down in Article 293(1)(c) of the CRR with respect to the terms of initial margin agreements, the ECB is of the view that the future composition of collateral over the lifetime of the netting set should reflect the portfolio levels that are relevant when assessing the own funds requirements and therefore the alpha parameter. Impacts at counterparty or portfolio levels may impact the risk monitoring framework of the institution, and therefore should be assessed as well, independently of the fact that the capital requirements are computed at group level. Consequently, no direct link with the alpha parameter should be made. However, when representative scenarios are used as a basis for the risk assessment, it is relevant to consider the impact on sub portfolios when they are used as an additional assessment of the model performance.

Institutions should be allowed to elaborate on excluding posted IM from IMM if deemed more appropriate for the purpose of risk management, as long as the impact is assessed in a consistent manner.

The property of the risk model and the underlying exposure processes (such as drift, volatility and correlation) for internal risk management should be at least the current composition of margin. If different, the current composition of margin should be explicitly stated. The difference should be justified and documented, taking into account the nature of the change and the impact on risk management.

Institutions should be allowed to elaborate on excluding posted IM from IMM if deemed more appropriate for the purpose of risk management, as long as the impact is assessed in a consistent manner. This also applies to the requirement that certain tasks are executed by model developers and/ or practitioners. Institutions should be allowed to elaborate on excluding posted IM from IMM if deemed more appropriate for the purpose of risk management, as long as the impact is assessed in a consistent manner.

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The rescaling of time interval is not mentioned in the CRR and is significant change in the interpretation of this article.

The good practice set out in paragraph 76 with respect to the portfolio composition during the observation window seems to be only relevant for approaches above.

Please note that back-testing approaches on actual portfolios are, but are not limited to:

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In our view the wording of paragraph 76 should allow for other good practices with respect to back-testing of actual portfolios.

Besides, the requirement in paragraph 68(a) that “the validation task is conducted on behalf of the validation function” can be interpreted in different ways and it is not clear, how this could be implemented organizationally.

But paragraph 68(b) describes “a regular, independent and effective challenging of the underlying methodological aspects of the respective validation task” as necessary, which implies that such methodological aspects could be designed by the model development function, which may be a contradiction.

The formulation of requirements in paragraph 68 looks overly simple and convincing. The paragraph refers to the case of “internal operations” and the validation framework “e.g. back-testing” being monitored by model developers and aims to define, under which circumstances such a framework “e.g. back-testing” can be conducted, if no independent and effective challenging of the underlying methodological aspects of the respective validation task is, as necessary, which implies that such methodological aspects could be designed by the model development function, which may be a contradiction.

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It should be noted that by their very nature model validation activities are often performed at lesser frequency, than those present in the validation framework “e.g. back-testing” runs or benchmarking of IMM pricing functions, are conducted by staff also responsible for model design and development. In our view, a setup where model performance assessment methodology is developed by either a specialized unit or model development unit and then independently assessed by the model validation function, as any additional independent and effective challenging of the underlying methodological aspects of the respective validation task is, as necessary, which implies that such methodological aspects could be designed by the model development function, which may be a contradiction.

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