European Federation of Building Societies
Fédération Européenne d'Epargne et de Crédit pour le Logement
Europäische Bausparkassenvereinigung

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EFBS position paper on Guidelines on PD estimation, LGD estimation and the treatment of defaulted exposures (EBA/CP/2016/21)

The European Federation of Building Societies (EFBS) is an association of credit and other institutions promoting and supporting the financing of home ownership. Its purpose is to encourage the idea of acquiring home ownership in a Europe that is converging both politically and economically.

The members of the EFBS are specialised credit institutions established in seven Member States (DE, AT, RO, SI, HR, CZ and HU). The business of the Bausparkassen is regulated by specific national Bausparkassen Acts. In compliance with the strict legal provisions, the Bausparkassen offer contractual savings schemes to their customers and grant them loans which must be secured by mortgage. They are not allowed to practise other forms of banking business. They may invest their excess liquidity only in particularly secure investment products, such as government bonds of EU Member States. Bausparkassen are subject to specific supervision by the national authorities. In the context of Bausparen the interest rates on savings and loans are fixed in advance and are usually lower than the market interest rate. In most Member States, Bausparkassen must obtain specific approval from the supervisory authority before offering a new tariff or a new product on the market. As part of this product testing, Bausparkassen must prove the sustainability of their products and tariffs.

The EFBS supports the endeavours of the EBA to boost confidence in the use of internal rating systems. However, in the efforts to limit unjustified variability of the results of internal models, some proposals are also made which, through new specifications, would restrict institutions' freedom of choice of methods to such an extent that the institutions would no longer be able to draw up the best possible risk forecast for their risk assets. Because the drafted guidelines are generally geared towards being more conservative, the overall impact will be unintended increases in capital requirements. This would apply even where institutions were already able to establish the appropriateness of the procedures and the underlying assumptions under the IRBA approval tests.

New methodological specifications often can be implemented only at considerable expense, since, all other things being equal, not only do individual input variables frequently require adaption, but also the development and validation process has to be carried out again for all risk parameters of the IRB approach. For reasons of consistency, procedures outside the IRB approach are also often affected by new specifications. The proposed changes will in many cases result in material adaptations in systems and processes of lending decisions, risk provisioning, pricing, credit portfolio models, reporting and data storage, and lead to notifications of key changes to models to the supervisors and renewed approval tests. In our opinion, the total expense involved in implementation of the guidelines in the draft version is not justified for procedures which have already been proved to be appropriate, because in general no feasible substantial improvement in the forecasts is identifiable.

The EBA also expects that the guidelines will give rise to a need for adaptation in a large number of rating systems. Based on current information, institutions must assume that, as a result of the combination of the guidelines with new EBA requirements, especially with a view to the definition of default, the assessment criteria in the IRB approach and the specifications on consideration of economic cycles, and as a result of the interaction of the guidelines with the design of expected credit loss models in accordance with IFRS 9, nearly all IRB models of the institutions in Europe will shortly again have to be accepted by the banking supervisors.

The process of implementing new IRB models on specific portfolios - including the dialogue and approval from the competent authorities - typically takes years. Because it is proposed to apply the guidelines from 1 January 2021, efforts would have to be made by the institutions for the IRB tests to be carried out in a prior, very narrow time-frame. Hence the question arises not least of how the banking supervisors are going to cope with the abundance of impending tests.

Delays in the IRBA approvals would have a very detrimental effect on the institutions. Since the model changes and testing will require the institutions to keep a high level of resources available, but are also associated with necessary business policy and strategic specifications, such as, for example, the IT release planning and the capital planning, the planning capability of the implementation periods will assume highly critical importance for the institutions.

On the basis of these considerations, we urgently request the EBA for simplifications of the requirements and for an extension of the time for their introduction.

We welcome the opportunity to reply below to some of the questions raised in the consultation paper.

4. General estimation requirements

4.4 Margin of conservatism (MoC)

Q 4.1: Do you agree with the proposed requirement with regard to the application of appropriate adjustments and margin of conservatism? Do you have any operational concern with respect to the proposed categorization?

We reject the additional requirements, since the requirements for security margins are in our view sufficiently regulated in the CRR. Security margins are therefore already comprehensively taken into consideration in the IRB models.

The conceivable deficiencies of the estimates in practice frequently cannot be differentiated unequivocally and unambiguously in accordance with points 24 and 25 and the categories (A to D) and subcategories described there. As a rule, neither the identification and definition of types of errors nor their quantification according to these granular categories and subcategories are possible in a meaningful way.

The requirements governing a process for the identification, quantification, documentation and monitoring of the various types of errors would in our view lead to considerable implementation

expense without thereby allowing perceptible reduction of the RWA variability of comparable portfolios.

5. PD estimation

5.5 PD estimation methodologies

Q 5.5: Do you have processes in place to monitor the rating philosophy over time? If yes, please describe them.

The freedom of methods enables institutions to choose the appropriate rating approach for the respective portfolio and the information available on it. Also the methodology (shadow rating approaches v scorecard-based procedures) would be likely to influence the choice of approach.

In practice, there are few pure through-the-cycle or point-in-time approaches, but many hybrid forms, so explicit stipulation of a rating philosophy, as called for in point 78, seems problematic. Point 78 should therefore be deleted.

Q 5.6: Do you have different rating philosophy approaches to different types of exposures? If yes, please describe them.

The parallel use of different rating approaches for the PD estimate is as a rule not logical for Bausparkassen, with their focus on financing of home ownership and accordingly homogeneous loan portfolios.

Explicit stipulation of a specific rating philosophy does not usually occur. We refer to the response to Q 5.5.

6. LGD estimation

6.2 Data requirements for LGD estimation

Q 6.1: Do you agree with the proposed principles for the assessment of the representativeness of data?

We reject the requirements concerning the representativeness of data because implementation would be very costly without any recognisable added value.

In our opinion, there are valid situations which justify disregarding a dataset for methodological reasons, for example if it relates to products which are no longer sold and so belong to an expiring portfolio. In this case, excluding the dataset would usually even improve the forecasting quality.

6.3 Calculation of economic loss and realised LGD

Q 6.3: Do you agree with the proposed specification of discounting rate? Do you agree with the proposed level of the add-on over risk-free rate? Do you think that the value of the add-on could be differentiated by predefined categories? If so, which categories would you suggest?

We reject the proposal on specification of the discounting rate, especially because we cannot understand the justification for an add-on that reflects the average level of a risk premium and which is to amount to 5 percentage points.

The EURIBOR interbank rate referred to in the explanation box is not a risk-free interest rate, but comprises the volume-weighted average risk premium for banks and in our view – without add-on – can therefore represent an appropriate discounting rate.

Because in our opinion there is therefore no reason for a risk premium, we advocate retaining the current requirements, which allow an appropriate procedure to be followed. The use of an appropriate interest rate for discounting cash flows was discussed in detail by the institutions with the banking supervisory authorities at national level in the context of a large number of approval tests on the IRB approach. In our opinion, the current requirements have also led to desirable model and method stability.

6.4 Long-run average LGD

Q 6.5: Do you agree with the proposed treatment of incomplete recovery processes in obtaining the long-run average LGD?

We do not agree with the proposed treatment of incomplete recovery processes to obtain the realised LGDs because we consider that this would give rise to a large amount of uncertainty and arbitrariness in the estimate.

Points 131 and 135 can be interpreted to mean that in each case it is compulsory to consider all datasets. From the methodological point of view, this gives rise to considerable concern because then outlier values could lead to distortions in the historical, and subsequently also in the forecasted values. In order to be able to avoid distortions in the model forecasts, the institutions need the possibility with justification to disregard certain datasets.

According to the experience of the Bausparkassen, consideration of the year of clearing a recovery yields a more accurate forecast to obtain the realised LGDs than consideration of the year of default, as suggested by the draft. In the case of loans secured *in rem*, the expected future proceeds from realisation are obtainable only at a very late point in time, i.e. only after a sometimes protracted realisation period. Therefore information related to incomplete recovery processes is not very helpful here.

The requirements under point 138 seem to us to be of little use in practice. On the basis of the requirements, several sub-models would be needed in order to be able to develop an LGD model.

The proposed approach therefore requires an estimation within the estimation. In our opinion, this would also be counterproductive for the LGD model in view of the objective to reduce RWA variability, since the uncertainty and variance of the model forecasts would necessarily be increased as a result. The desired stability of the models would decrease.

7. Estimation of risk parameters for defaulted exposures

7.1 General requirements specific to ELbe and LGD in-default estimation

Q 7.1: Do you agree with the proposed approach to the ELBE and LGD in-default specification? Do you have any operational concerns with respect to these requirements? Do you think there are any further specificities of ELBE and LGD in-default that are not covered in this chapter?

The use of the methods for the estimation of LGD for non-defaulted exposures for the estimation of ELbe and LGD in-default is not suitable in every case for Bausparkassen. A derogating approach for the sub-model of defaulted exposures is often chosen in order to obtain more accurate estimation results. We should like to state that cliff effects anyway cannot be completely avoided but only postponed to a certain point in time. Even if there is no structural break in the LGD estimation at the moment of default, there will be a break later on, for example when the loan contract is cancelled or revoked or when collateral is liquidated.

Identity of methods would also not reduce the RWA variability. We therefore consider it necessary to leave institutions freedom of choice of methods and not to burden them with any unnecessary conversion expense. The requirement in point 159 should therefore be deleted.

7.4 Calculation of realised LGD and long-run average LGD for defaulted exposures

Q 7.3: Do you agree with the proposed approach with regard to the treatment of incomplete recovery processes for the purpose of estimating LGD in-default and ELbe

The requirement to establish reference datasets to determine LGDs from them and to allow them to be incorporated in the model does not seem advisable for many institutions and for many portfolios. Implementation would often be methodologically questionable and would give rise to very high expense.

Instead, we prefer a simpler approach allowing the possibility of disregarding certain datasets on incomplete recovery processes, with justification, so that the quality of the LGD estimation is not impaired. We refer to our replies to Q 6.5 and Q 7.1.

Q 11.1: How material would be in your view the impact of the proposed guidelines on your rating systems? How many of your models do you expect to require material changes that will have to be approved by the competent authority?

As stated at the beginning, on the basis of a first assessment, we assume that all IRB models will require material changes, which means that in each case an IRB acceptance test will be necessary.

Yours sincerely,

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