Comments

on EBA Consultation Papers:

Draft Regulatory Technical Standards on the specification of the nature, severity and duration of an economic downturn in accordance with Articles 181(3)(a) and 182(4)(a) of Regulation (EU) No 575/2013 (EBA/CP/2018/07)

Guidelines for the estimation of LGD appropriate for an economic downturn ('Downturn LGD estimation') (EBA/CP/2018/08)

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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 1,700 banks.

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1. General comments

On 22 May 2018, the EBA published two consultation papers (90 pages in total) on which comments were only possible until 22 June 2018. In principle, we welcome this opportunity to comment. However, we consider the one-month consultation period to be unreasonably short. A hearing shortly after the publication of the papers is also not appropriate, because an in-depth examination of the consultation papers and hence a discussion with the EBA is hardly possible on this basis. The EBA should not give the impression that consultations and hearings are merely a tiresome exercise in playing by the rules that it has to undergo for formal reasons, but without really being interested in feedback from the industry. For future consultations, we expect a consultation period that is appropriate to the scope and complexity of the matter in question, and hearings that are ideally held after the end of the consultation period.

The GBIC welcomes the EBA's intention to simplify the estimates by allowing the downturn to be identified independently of the LGD estimation methodology.

Contrary to all previous EBA papers as well as previous downturn consultations, paragraph 5 of EBA/CP/2018/07pulls forward the implementation deadline, with the rules governing downturn phases already set to enter into force on **31 December 2019**. As the end of the consultation period on 22 June 2018 means that the paper is not expected to be finalised until the end of 2018 at the earliest, the implementation time for the institutions will be disproportionately short. This applies all the more if institutions do not currently have time series for all the economic factors required in paragraph 2(1) and will therefore have to find external data providers and sign corresponding contracts.

In our view, the methodology for determining the downturn phases also continues to influence the options for modelling the downturn in the LGD and CCF model. However, according to EBA/CP/2018/08, the requirements for this will continue to be mandatory as at 31 December 2020. This would mean that any currently available methodology for modelling the downturn that has to be revised as at 31 December 2020 would have to be adapted again for one year in between on the basis of the old estimation methodology in order to take into account the new downturn phases to be determined. In our view, this constitutes disproportionate additional effort for the institutions. We assume that this is not intended by the EBA, but that pulling forward the deadline refers only to the identification of the downturn phase in the RTS, and not to the requirements of the LGD estimation in the Guidelines. We would ask you to clarify this accordingly in the final paper.

According to EBA/CP/2018/07 and EBA/CP/2018/08, an **institution-specific default and loss history of 20 years** is required in order to have a chance of avoiding the application of an MoC. We consider this to be a legally unacceptable tightening and hence a breach of the CRR requirements in Article 181(1)(j) and Paragraph 2 sentence 2 of the CRR (minimum data history). It is our understanding that, as a matter of principle, it must be possible for an institution that is new to IRBA approval and that meets the CRR requirements – and in particular the minimum data history requirements – to obtain approval without applying an MoC.

In the absence of historical institution-specific loss data for an economic downturn period, a strictly positive margin of conservatism (MoC) must be applied to the internal downturn LGD estimation for this downturn period in accordance with paragraph 32 of EBA/CP/2018/08. Furthermore, in accordance with paragraph 37(a) of "EBA/GL/2017/16 – Guidelines on PD estimation, LGD estimation and the treatment of defaulted exposures", an MoC must be applied if the default definitions are not consistent in the historical observation period.

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In accordance with Article 181(1)(j) of the CRR, for exposures to corporates, institutions and central governments and central banks, estimates of LGD must be based on data over a minimum of five years, increasing by one year each year after implementation until a minimum of seven years is reached, for at least one data source. If the available observation period spans a longer period for any source, and the data is relevant, this longer period must be used. However, according to Article 179(1) of the CRR, data collected prior to 1 January 2007 may only be used if appropriate adjustments are possible and have been made to achieve a broad equivalence with the definition of default in Article 178 or the definition of loss. Both CRR articles thus clash with a requirement of 20 years' default and loss history, so that an MoC is inevitably being forced on the institutions because there were economic downturns in the last 20 years, including before 2007 (in Germany, in particular the 2000/01 dotcom bubble). Either the institution has to accept an MoC because it has no default and loss data (that are representative of the current definition of default) for the crisis before 2007, or it has to accept an MoC because it uses internal data before 2007 based on a different definition of default. This runs counter to the EBA's own requirements in paragraph 50 of "EBA/GL/2017/16 – Guidelines on PD estimation, LGD estimation and the treatment of defaulted exposures" that institutions should develop a plan to rectify data and methodological deficiencies as well as any other potential sources of additional uncertainty, and to reduce the estimation errors within a reasonable timeframe.

According to paragraph 32 of EBA/CP/2018/08 and the preliminary remarks in section 3.6, following a previously very complex and time-consuming procedure for determining the downturn LGDs, they should be compared with a reference value calculated as the mean of the 2 years with the highest observed losses, and deviations from this value should be justified. We do not think this comparison makes sense and therefore reject it and urge the complete deletion of section 8. If the institutions submit to the complex requirements for deriving the downturn LGD per downturn phase and calibration segment in accordance with section 5 – i.e. with good data availability – there is no need for a simple and (among other things) therefore methodologically questionable comparative value in the reference value approach. In a situation under section 7 in which an impact cannot be observed, the reference value approach again makes no sense. Generally speaking, short histories are available in the situations described in sections 6 and 7. This, too, means that the reference approach – based on a 20-year history – will generally not yield any useful results.

Additionally, since no questions are asked about the derivation of the downturn LGD estimation based on observed impacts (paragraphs 22 to 24 of EBA/CP/2018/08), we would like to make our comments on these points in advance:

According to the analyses in paragraph 22a of EBA/CP/2018/08, the effect on realised LGDs, the number of recoveries and workout periods in the default year are to be determined, while the amounts recovered should be grouped together. According to the explanations in section 3.3, this different perspective is explicitly desired in order to avoid impacting the amounts recovered by significant catch-up effects due to late recoveries. From our point of view, however, this argument does not take into account the higher discounting effects due to late recoveries. Furthermore, it may make strategic business sense for institutions to wait until the markets recover before liquidating the collateral in order to obtain higher selling prices from the collateral and to accept higher discounting to achieve this. Since the internal estimators for the risk parameters under Article 179(1)(c) and (d) must be consistent with the institution's processes, a workout strategy of waiting to realise collateral (particularly common in the real estate sector) until the markets recover should also be reflected in the amounts recovered under downturn conditions. The requirement in paragraph 23 of EBA/CP/2018/08, which in these circumstances – together with the explanations in section 3.3 – requires the LGDs realised in the case closure year to be considered for the quantification of the downturn LGD estimators, thus breaches the cited requirement of the CRR. In our

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opinion, an RWA estimation must also be based on the consistent timing of the PD, LGD and CCF estima-tion. Since the conditional PD estimation calculated in the CRR is adjusted to the default date in a down-turn, the downturn LGD estimation must also be grouped together to the default date and not to the date of recovery/closure of the case

However, in addition to the above, we would like to propose allowing greater flexibility in the procedure, which we would like to illustrate using the following alternative:

In both the retail and non-retail segments, the effect that a default in a downturn phase leads to lower LGDs (despite higher discounting effects) may well be evident. This is due to the fact that a) as already mentioned, any workout or enforcement may be delayed until the end of the economic downturn, and b) even if there is a regular workout process, cash flows are probably expected to be received towards the end of a default phase of, for example, 3-4 years. By this time, the markets may already have recovered in any case, so better prices can be achieved. It can also be observed in enforcement practice that the duration of the enforcement process is considerably shorter for recoveries than for write-offs. This can also result in a situation in which there is an increased default rate during a downturn, which then leads to a short-term increase in the recovery rate. In our view, it would be more relevant to assign defaults to downturn years on the basis of the points in time when most cash flows are regularly realised (analysis e.g. by individual case). An individual segmentation year would therefore have to be determined for each individual LGD observation in order to obtain an undistorted picture of any cyclical dependency. Using the default date therefore seems to us to be entirely inappropriate. According to the PD/LGD Guidelines, the maximum period after which cash flows can no longer be expected must be determined for the inclusion of uncompleted cases in the calibration. If this requirement is applied to the downturn framework, it could be possible to derive a suitable segmentation year for the downturn analysis.

We would like to point out that, particularly in non-retail portfolios, a customer is more likely to be classi-fied as in default in downturns than in upturns – due to the lower likelihood of repayment – reflecting the economic conditions. Since some of the defaults may be recognised under the principle of prudence, it is by no means implausible (albeit counterintuitive) that the number of recoveries of defaults that were trig-gered in downturns is higher than would otherwise be the case and, as evidence required under para-graph 22(a)(iii) in EBA/CP/2018/08, an increase in recoveries is more likely to be expected than a de-crease. This is especially the case in short downturns. The formulations in paragraph 23 of EBA/CP/2018/08 should therefore be modified in such a way that observed compensatory effects, e.g. an increasing recovery rate in downturns, are taken into account when combining analyses of the observed downturn. If this is not the case, there will be no LGD estimates that are appropriate for an economic downturn, as required by Article 181(1)(b) of the CRR, but rather a risk overestimation.

2. Specific comments (EBA/CP/2018/07)

Q1. Do you have any concerns around the workability of the new approach (e.g. data availabil-ity issues, burden on the analysis, split between the definition of the economic downturn and its impact on the internal loss data)?

Paragraph 1(3) calls for a separate evaluation of downturns per jurisdiction. This can become very oner-ous for globally active companies and, if there are only a few exposures in this jurisdiction, it may also lead to less meaningful results in the subsequent evaluation of the loss data realised in this jurisdiction. It should also be possible in this case to determine the downturn impact on the LGD globally in the event of global crises that have affected (almost) all jurisdictions in at least one economic factor.

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In our opinion, identifying the time series for externally provided default and loss rates required in Article 2(1)(a)(iii) and (iv) constitutes an excessive effort, considering that external data are actually available for this at the end. Furthermore, it is not clear how pool data should be viewed in this context.

Article 3(1)(b) only allows a shorter observation period than the preceding 20 years if the economic factor under consideration has been subject to significant changes due to the country's accession to the EU. In our opinion, this can at best be an example, which should also be identified as such.

In principle, there may also be a significant change in the time series for individual economic factors in many other scenarios, leading to severe characteristics in the time series that are independent of the economic environment. In Germany, for example, the "Hartz IV" reforms in 2005 changed the way the jobless numbers are counted, and meant that former recipients of social welfare benefits who are unfit for work now also count as unemployed – in contrast to the previous years. This results in a peak in the German unemployment rate in 2005 that is not related in any way to economic downturn conditions. Unemployment statistics for Germany adjusted for this effect are not available. In cases like this, it should be possible either to consider this economic factor only from the time of the significant change or to neglect the peak year 2005 as a downturn period. In general, with regard to the problem of breaks in time series, we would propose reverting to the more generous requirements of the first RTS draft.

> **Q2. Do you see any issues of applicability of this RTS for estimating conversion factors appropriate for an economic downturn identified in accordance with this RTS?**

n/a

3. Specific comments (EBA/CP/2018/08)

> **Q1. Do you think that additional guidance around the estimation of LGD in-default, which reflect downturn conditions, is needed? If yes, could you provide examples of sound methodologies for transposing downturn LGD estimates from performing to non-performing exposures?**

Depending on data availability, it should generally be left open as to how the LGD in default is derived under downturn conditions for the individual downturn phases. For example, if a relative increase of 20% over the long-term average was determined for the LGD for the living portfolio under downturn conditions, it can be expected that for the LGD in default, which analyses partial cash flows of the LGD for the living portfolio, there will also be a mean relative increase of 20% due to downturn effects. Taking into account the complexity of determining the LGD for the living portfolio under downturn conditions, such reconciliations to the LGD in default should also be permitted, and no determination of the downturn effect on the LGD in default per reference time should be required.

> **Q2. Do you share the concern that the proposed policy in paragraph 15 could create an undue burden if applied to every downturn period identified? If yes, in order to better balance the accuracy of the estimations and its operational complexity what evidence should be provided by institutions in order to justify the exemption of identified downturn periods from the proposed policy in paragraph 15?**

From our point of view, it seems unnecessarily complex to consider all downturn phases for all calibration segments and all jurisdictions. This is especially the case when the informative value for downturn phases long in the past is already limited due to the availability of relevant loss data, and the most recent crisis exhibits a more pronounced impact overall on the economic factors than previous crises.

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Also, as mentioned above, in the case of global crises that have affected at least one economic factor in (almost) all jurisdictions, it should then be possible to determine the influence of this crisis on the LGD globally. This can make sense in particular for low default portfolios in order to be able to observe a downturn impact in the first place, and not to distort it by statistical fluctuations due to the required distribution of observations.

> **Q3. Do you agree with the proposed level of downturn LGD estimation set out in paragraph 14? In particular, do you support the concept that the downturn LGD estimates of different calibration segments could be based on different downturn periods? Is the policy on the level of downturn LGD estimation as well as the relation between the level of downturn LGD estimation and the relevant downturn periods sufficiently clear?**

Depending on how the calibration segments are formed, it may also make sense to start from common downturn phases and, especially for low default portfolios, to measure the downturn effect across all calibration segments and to compare the long-run average LGD also measured at the overall level. For example, if a relative increase of the LGD by x% under downturn conditions compared with the long-run average LGD can be observed at the overall level, the long-run average LGD determined for each calibration segment could be multiplied by the factor (1+ x%) in order to obtain a downturn LGD per calibration segment.

The following example illustrates the problem:

Especially with low default portfolios, determining the downturn impact at the level of the calibration segment can be difficult because there are not enough observations. For example, an institution has over 200 defaults and related observed LGDs over an observation period of 10 years. The institution has established 4 calibration segments for the LGDs with 50 cases each. This results in the following long-run average LGD, for example for calibration segments:

1: 10%

2: 15%

3: 20%

4: 25%

At the level of the overall portfolio, the average LGD is 17.5%.

In order to determine the development of the LGDs observed over time, the LGD per default must be determined. If this development is analysed at the level of the calibration segments, there are on average only 5 cases per year for which an average value is determined. These averages are statistically very uncertain due to the very low number of cases. Consequently, the downturn impact at the level of the calibration segment can be very distorted.

In this case, we believe that it would make more sense to monitor the development of the realised LGDs over time at the level of the overall portfolio. This would mean an average of 20 cases per year and the statistical uncertainty would be considerably lower. If a realised LGD of 28% is now observed at the overall level for the downturn phase, this then corresponds to a relative increase of 60% compared with the long-run average LGD of 17.5% at the overall level. This 60% increase at the overall level must also be

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reflected on average at the level of the calibration segment. Consequently, the downturn LGD can be derived for each calibration segment by multiplying the corresponding long-run average LGD by 1.6 (x=0.6) per calibration segment. This results in the following downturn LGD per calibration segment:

1: 16%

2: 24%

3: 32%

4: 40%

Observing the downturn impact at the overall level and transferring it to the calibration segments should therefore be a permitted option in low-default portfolios.

Q4. Do you consider the description of the approaches in section 6 to be sufficiently clear?

In the event that a longer downturn phase than 12 months has been identified in a downturn due to time lags in the economic factors, there is no clear definition of which corresponding values should then be used for the economic factors in the haircut or extrapolation approach:

- For any economic factor that has its most pronounced value in this multi-year downturn phase, the worst outcome, even if the peaks and valleys do not occur in the same year? or

- Average value over the multi-year downturn phase per economic factor? or

- Calculate each year individually with the correspondingly observed values?

Similarly, in the case of multi-year downturn phases, there is no clear definition of which values are to be applied for the economic factors that do not have their most pronounced value in this multi-year downturn period:

- worst during this downturn period or

- average value or

- calculate each year separately?

In our opinion, however, the lack of a precise definition should be avoided. The institutions should develop portfolio-specific meaningful requirements that would have to be approved by the auditors.

Article 30 requires a strictly positive MoC in category A if a haircut or extrapolation approach is applied for downturn LGD estimation. As a general rule, this MoC should be able to be equal to 0 with corresponding evidence, for example in the case of the haircut, that the model reacts sufficiently sensitively to the economic factors. Such evidence could be provided, for instance, by calculating the LGD with the haircut method comparatively for another downturn phase in which relevant loss data is available and the LGD downturn was determined in accordance with section 5. If it can be demonstrated that the LGD determined for this downturn phase using the haircut method is greater than or equal to the LGD based on observed impacts in line with section 5, then no MoC should be required for earlier downturn phases when the haircut method is applied.

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Q5. Do you agree to the limitation of approaches for quantification of downturn LGD estimates? If not, which other approaches should be considered? Would you prefer the alternative policy considered – if yes how should a minimum MoC be established in this case?

The general idea to extrapolate an downturn add-on from a macroeconomic time series which covers a longer time period than the observed loss data is comprehensive, but from our point of view the results of the extrapolation approach described in paragraph 49 et seq. may be inappropriate and unreliable.

The general assumption of the approach is that a dependency between observed realised LGDs and macroeconomic variables exist. This is probably true given a long observation period with different macroeconomic circumstances, but may not apply for any observation period. Nevertheless, in particular given a retail portfolio with a large number of observations, a statistical model may derive a dependency between the observed realised LGDs and a macroeconomic factor although the underlying observation period covers a stable economic environment. In fact, the derived dependency is just a pseudo-correlation and the LGDs obtained by backward extrapolation are unsuited for calculation the downturn add-on.

Example:

Assume a macroeconomic factor 'a' varying between 98 and 102 during the observation period. Given the framework described above the result might be a simple linear model: $LGD = 1.5 - 0.01*a$. If the macroeconomic factor drop off by ~20 percent to 80 during a downturn period the LGD would increase by ~40 percent which is in particular not plausible for a retail portfolio.

Moreover we like to annotate that it may not even be possible to calculate a downturn add on by the proposed extrapolation approach if the dependency between the observed realised LGD and the macroeconomic factor does not lead to higher LGDs during the downturn period, which is in fact possible even given a stable portfolio.

Finally, paragraph 51 points out that a MoC has to be considered if the extrapolation approach is used to cover the resulting uncertainty. However, the approach may already lead to very conservative estimates.

Q6. Do you expect that the total exposure amount or share which is treated with the policy proposed in Section 7 is material?

We presume that section 7 will be of greater significance at least for some institutions.

Q7. Do you have specific examples of types of exposures which will fall under the policy proposed in Section 7?

In principle, this could particularly affect certain jurisdictions such as China or other emerging markets, but also developed markets where no real crisis has been observed in the last 20 years and where prolonging the data history does not seem reasonable for reasons of representativeness. It should therefore be possible to take over downturn impacts observed globally or for similar jurisdictions in these cases.

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Q8. Do you agree to require a minimum MoC quantified via a fixed add-on to the long-run av-erage LGD? If not, which of the alternatives should be considered? Do you see reasons for dif-ferentiating the fixed add-on according to exposure classes?

Q9. Do you agree to the minimum MoC as the max(0,min(20%, 105% - LRAVLGD)?

The GBIC is critical of the fact that the MoC in the situation described in section 7 is excessively con-servative (31(b), p. 42, 20% floor). A fixed add-on of 20% is too high. It should also be considered that this floor must be regarded as cumulative with the input floors decided under Basel IV. It should be noted that lending values as inputs are already geared to the long term. In addition to real estate this also ap-plies to other categories of collateral. Of course the 20% should also cover reduced recovery rates and reduced contributions in a recession, but we still think 20% is too high. We think the hierarchical ap-proach is positive and flexible.

Q10. Is the policy regarding the reference value sufficiently clear? Alongside with the poten-tially limited applicability of the reference value to the downturn LGD estimation according to paragraphs 18-19, for what reasons could the reference value feasibly be omitted? Do you agree to the proposed clarification of the role of the reference value?

Paragraph 32(a)(ii) is not clearly defined because the highest realised ratio to the EAD does not neces-sarily have to be accompanied by the highest economic loss in the numerator in the case of greater EAD portfolio fluctuations.

According to EBA/CP/2018/07 and EBA/CP/2018/08, an institution-specific default and loss history of 20 years is required in order to have a chance of avoiding the application of an MoC. We consider this to be a legally unacceptable escalation and hence a breach of the CRR requirements in Article 181(1)(j) and Paragraph 2 sentence 2 of the CRR (minimum data history). It is our understanding that, as a matter of principle, it must be possible for an institution that is new to IRBA approval and that meets the CRR re-quirements – and in particular the minimum data history requirements – to obtain approval without ap-plying an MoC. In the absence of historical institution-specific loss data for an economic downturn period, a strictly positive margin of conservatism (MoC) must be applied to the internal downturn LGD estimation for this downturn period in accordance with paragraph 32 of EBA/CP/2018/08. Furthermore, in accord-ance with paragraph 37(a) of "EBA/GL/2017/16 – Guidelines on PD estimation, LGD estimation and the treatment of defaulted exposures", an MoC must be applied if the default definitions are not consistent in the historical observation period. In accordance with Article 181(1)(j) of the CRR, for exposures to corpo-rates, institutions and central governments and central banks, estimates of LGD must be based on data over a minimum of five years, increasing by one year each year after implementation until a minimum of seven years is reached, for at least one data source. If the available observation period spans a longer period for any source, and the data is relevant, this longer period must be used. However, according to Article 179(1) of the CRR, data collected prior to 1 January 2007 may only be used if appropriate adjust-ments are possible and have been made to achieve a broad equivalence with the definition of default in Article 178 or the definition of loss. Both CRR articles thus clash with a requirement of 20 years' default and loss history, so that an MoC is inevitably being forced on the institutions because there were eco-nomic downturns in the last 20 years, including before 2007 (in Germany, in particular the 2000/01 dot-com bubble). Either the institution has to accept an MoC because it has no default and loss data (that are representative of the current definition of default) for the crisis before 2007, or it has to accept an MoC because it uses internal data before 2007 based on a different definition of default. This runs counter to the EBA's own requirements in paragraph 50 of "EBA/GL/2017/16 – Guidelines on PD estimation, LGD estimation and the treatment of defaulted exposures" that institutions should develop a plan to rectify

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data and methodological deficiencies as well as any other potential sources of additional uncertainty, and to reduce the estimation errors within a reasonable timeframe.

According to paragraph 32 of EBA/CP/2018/08 and the preliminary remarks in section 3.6, following a previously very complex and time-consuming procedure for determining the downturn LGDs, they should be compared with a reference value calculated as the mean of the 2 years with the highest observed losses, and deviations from this value should be justified. If harmonisation of the model results is to be achieved mainly by using a reference value, we believe that the complex requirements for deriving a downturn LGD for each downturn phase and calibration segment are unnecessarily detailed and onerous for the institutions.