

20/06/2018

European Banking Authority

Consultation on Guidelines for the estimation of LGD appropriate for an economic downturn

General comments

- We welcome that the EBA is seeking to simplify LGD estimation by making the identification of downturn independently from the LGD estimation methodology. However, we have some serious concerns regarding other proposals. We understand and support the overall purpose to harmonise, but the proposals add uncertainty in some areas.
- The time frame for introducing the changes is very tight. Both banks and supervisors need time to study the effects of the proposals in order to understand the full extent of the proposed changes. We suggest a QIS be conducted both at EU level, and in some cases at national level (see response to question 9 below).
- It is not clear on which level calibration shall be performed. Our preliminary assessment is that with this setup, a more granular estimation methodology will result in a more conservative approach. This in turn gives a disincentive to differentiate between various subsegments. We doubt there will be any incentives to differentiate other than between real estate exposures and other exposures, which will make modelling less risk sensitive. We seek clarity on level of calibration and would like to know if proposed methods are designed with purpose to steer institutions towards broader estimation segments.
- For banks which will have to base downturn LDG estimates on external data, where external data is missing, both MoC and choice of haircut/extrapolation methods will become very important aspects, the add-on of 20% to the long term average appears to be very conservative.
- We are concerned about the fact that the proposal will have very different effects on banks in different member states. The effects will depend on if there is recent experience of a financial crisis or not. For those countries who

have recently experienced a crisis, and where banks had internal models in place during that crisis, there will be sufficiently granular data on observed losses qualifying for the definition of economic downturn for banks in these jurisdictions to be able to model according to the first two options in the proposal. These banks then avoid the approach with the MoC add on. For most banks in Northern Europe, and the Nordics in particular this is however not the case. This may mean that banks in the Nordics may more or less automatically end up having to apply the most conservative alternative in the proposal, resulting in substantially higher risk weights for Nordic banks than if these banks would have been allowed to model "properly" as will be the case for banks which have relatively recently experienced a crisis.

Answers to the specific questions

Question 1: 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?

Yes, we believe it would be good to include writing similar to the one proposed on LGD in default. I.e., that same downturn component may be utilized to downturn adjust LGD in default estimates.

Additional paragraphs which highlight that LGD in-default appropriate for a downturn could be estimated based on the downturn methodology performed for the LGD estimates of non-defaulted exposures could be added.

Question 2: 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?

The proposed policy in paragraph 15 could create undue burden if applied to every downturn period identified.

To reduce operational burden, a simplified approach would be to compare loss data with the relevant economic factors. If losses do not increase as a result of economic factors indicating a downturn period, even if introducing an appropriate time lag, that should be enough evidence to exempt the identified downturn period from the proposed policy in paragraph 15.

Evidence as structural breaks could be documented by the institution and approved by the supervisor.

If the economic factors analysis reveals different downturn periods, one could consider using the average of the different downturn periods instead of the worst of the worst.

Question 3: 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?

It is not clear on which level DT should be identified and we believe that this may cause undue variation. It will be more beneficial from a capital planning point of view to have fewer grades or pools, although from a steering point of view this could potentially drive risk. If estimates shall be based on the worst observed crises, then the more granular you get in estimation the less you may benefit from diversification effects. I.e. the granularity level of estimates may have a significant impact on DT estimates.

More details could be provided i.e. the proposed level of the downturn LGD estimation and the relation to the downturn periods and economic factors could be more detailed.

There seems to be an issue with the granularity. The proposed policy in the GL allows to quantify downturn LGD estimates at a more granular level than the long-run average LGD estimates (in the case where this provides more appropriate downturn LGD estimates).

Question 4: Do you consider the description of the approaches to be sufficiently clear?

Yes.

Question 5: 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?

Yes. However, we see a potential driver of undue variation in adapting external time series to internal ones. In particular, variations may be significant due to how discounting (5 % add-on) and time in default is accounted for in external data.

Competent authorities have an important responsibility in assuring there is a level playing field across banks.

It's positive to harmonise the best practice and limit the approaches for quantification of downturn LGD estimates.

Question 6: Do you expect that the total exposure amount or share which is treated with the policy proposed in Section 7 is material?

It is impossible to answer the question as it is unclear when supervisory authorities will find extrapolation methods non-applicable. Given a strict interpretation and reliance on data from 1990's this may be a large share of non-retail portfolios.

The impact can be both material and immaterial. The 20% add-on seems conservative and LGDs might be overestimated. A better understanding of the chosen 20% as add-on is needed.

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

Corporate exposures not secured by real estate may fall within this category.

Question 8: Do you agree to require a minimum MoC quantified via a fixed add-on to the longrun average LGD? If not, which of the alternatives should be considered? Do you see reasons for differentiating the fixed add-on according to exposure classes?

We would suggest a QIS to detect possible differences between different exposure classes, type of collaterals and geographical region (i.e. legislation). It should not be beneficial to use add-on but neither should you be heavily punished for having to use MoC due to the fact that it has not experienced a crisis during recent years.

As stated in the answer to Q6 above, the chosen 20% add-on needs to be justified. It seems conservative for specific portfolios. The 20% add-on could be replaced by the reference value approach.

Question 9: Do you agree to the minimum MoC as the $\max(0, \min(20\%, 105\% - LRAVLGD))$?

We would suggest a QIS to see if 20% unit add-on is feasible, see answer to Q6 and Q8.



Question 10: Is the policy regarding the reference value sufficiently clear? Alongside with the potentially 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?

Yes.

The reference value approach seems to be sufficiently described. However, the calculation of the reference value might be problematic in some cases. In pools with a low number of facilities, the calculated reference value might be more impacted by the low number of facilities than the losses.

For structural models there might be correlation effects between the components.

SWEDISH BANKERS' ASSOCIATION

Hans Lindberg

Maria Olin