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FRENCH BANKING FEDERATION RESPONSE TO THE ECB CONSULTATION RELATIVE TO TRIM

The French Banking Federation (FBF) represents the interests of the banking industry in France. Its membership is composed of all credit institutions authorized as banks and doing business in France, i.e. more than 390 commercial, cooperative and mutual banks. FBF member banks have more than 38,000 permanent branches in France. They employ 370,000 people in France and around the world, and service 48 million customers.

The French Banking Federation welcomes the opportunity to share its comment with the ECB on its draft guide relative to the *Targeted Review of Internal Models – TRIM,* which will be conducted up to 2019.

The FBF broadly supports this exercice, as it will contribute to restore confidance in banks' regulatory internal models, and hopefully weigh on international regulations currently being discussed at the level of the Basel Committee, especially in relation to a possible output floor.

As a matter of fact the FBF is concerned about the direction, that the ECB is seeming to take for its TRIM exercise :

- The ECB Guide refers to several EBA mandates to develop level 2 texts, which are not yet in final version (case of guidelines) or not adopted by the European Commission (case of RTS). Therefore, banks are not expected to be compliant with articles which are not legally binding.
- Backtesting exercises should be made by the first line of defense :
    - The modelling entities are the expert of the models. This facilitates the recalibration process thus the model lifecycle process ;
    - The backtesting exercises are reviewed by the second line of defense which ensures an independent analysis and challenge against the first line of defense.

It is stated in the "Foreword" that the guide "sets out the ECB's view on the appropriate supervisory practices and how the EU law should be applied in a particular area": it is important however that the ECB reminds in its guide that the primary objective of the TRIM exercise should be to reduce RWA variability between banks under the current regulatory framework, and not ensuring compliance with possible future rules (for instance the future scope of application of the A-IRB approach) by front running non voted rules, as for instance Basel papers still under debate.

Accordingly, it would be worth for the ECB to explicitely make a distinction in its guide between expectations in terms of compliance with CRR-CRD IV that could lead to supervisory actions, and expectations in terms of preparatory work for progressively implementing futures regulations/guidelines which are still under discussions at international level and that could only trigger recommendations from our perspective.

In particular we would like to highlight the uncertainty and unclear supervisory decision process and consequences raised by the mentioned ”potential shortcomings as against the best practices defined in this guide”. In this respect, the ECB should specify that the draft guidelines and non voted RTS will not apply until they are finalised.

Finally, we believe that this comprehensive TRIM Guide would deserve more time for consultation and exchanges with banks, to assess the actual rationale and impacts of expectations therein.

You will find hereafter our members’ specific comments on targeted provisions of the ECB Guide.

ANNEX : FBF members' other main comments on ECB Guide

GENERAL TOPICS :
From articles 24 to 141, items seem to be specific to credit risk models, yet they appear in the "General Topics" section. We advocate for a consistent and explicit application of the general principles (including data quality framework requirements) to all types of internal models.

2. Overarching principles for internal models :
Paragraph 11:
We propose to replace the last sentence with : The senior management's decision making procedures relating ot all aspects of internal modelling, "including its delegation processes", should be clearly documented.

3. Roll-out & PPU :
Extending IRBA approach is a process which is long and complex, even more if the institution is of a large size. Best practices of risk management may exist even if exposures are not in IRB approach. Therefore, the threshold of coverage ratio of IRB exposures is not a relevant indicator of the quality of the risk management. We believe the proposed quantitative thresholds and the 5 years timeframe to reach the upper limit should not be maintained but rather take into account the diversification of the risk profile of the institution. We consider each bank should discuss its internal models deployment strategy with its supervisor. Tolerance should be introduced as institutions will not extend IRB on very small exposures if they fail to meet the coverage ratio for a few percents.

Paragraph 30: We do not agree on point 30 (b) stating that "General uncertainty caused by potential changes to the IRB regulatory requirements [...] approval." On the contrary, internal models roll-out plans are costly and can spread over several years; uncertainties in the regulatory landscape cannot be ignored in that respect.

4. Internal governance :
Jurisdiction should be taken into account while assessing the internal governance. Senior management is defined differently in the French transposition of CRD4 from the EBA definition in its GL about internal governance.

6. Internal validation :
Paragraph 54 : Clarification should be made on "arrangements, mechanics and processes used in the validation of rating systems".

Paragraph 55: We believe that asking for a complete validation of internal models at all levels (consolidated, sub-consolidated and individual levels) contravenes to the notion of global models and harmonization trends promoted by the ECB and request that this requirement should be limited to the impact assessments.

Paragraph 57(d)(viii) : We believe the "assessment of the use of the models and their correct application in practice" should be analysed on a periodic basis. Indeed this review can not be performed annually on all models, it is part of an pluri-annual audit plan informed by the general re-assessment which is itself annual. A deep dive is triggered if necessary and for instance when there are changes in processes, IT systems, etc.

Paragraph 63 : We suggest to exclude this article as documentation requirements should therefore cover this point.

Paragraph 65 : Our understanding is that the monitoring of the validation results and recommendations is reported to a sufficient decision-level which could encompass the CRCU.

7. Model use

Paragraph 72 : When the financial situation of a counterpart deteriorates, the downgrade of the rating may follow as well as the recovery process. Therefore, it is not relevant to expect that the recovery process will be triggered based on risk parameters.

8. Management of Model Changes :

Paragraph 90 : Nine months is considered as a minimum timeframe after reference date as the sum of the following periods :

- The modelling unit makes an assessment (2-3 months) ;
- The validation function reviews the assessment (3 months / 4-5 months if changes are material);
- The modelling unit takes into account any modification (1-2 months) ;
- Documentation and notification process (1 month).

Paragraph 98 : The requirement of immediate re-rating at the date of approval should be limited to retail exposures (with a tolerance time). For non-retail exposures, the re-rating process should be within one year from the date of implementation.
12 months is the appropriate timeframe for material and non-material cases in order to avoid any two-tier system.

Paragraph 100 : Regarding experience-test requirements, several comments :

- Regulation 529/2014 (Article 6)[1] mentions that changes to PPU or sequential implementation of internal approaches are excluded from the regulation. We do not understand why experience-test is tackled in the chapter "Management of Model Changes" for roll-out purposes. Generally, institutions already using IRB approaches have a thorough experience of IRB framework for years.
- We suggest to follow a "light process" especially regarding experience-test for particular cases (these cases could be part of roll-out plans). For example (this is not an exhaustive list) :

[1] "Changes to the permanent partial use of internal approaches or, where applicable, to the sequential implementation of internal approaches are covered by Articles 148 and 150 of Regulation (EU) No 575/2013 for IRB approach and Article 314 of Regulation (EU) No 575/2013 for AMA. Therefore those types of changes should not be covered by this Regulation."

- Buy-out action : an institution ‘A’ which buys another institution ‘B’ with similar exposures where institution ‘A’ uses IRB approach and the final entity should be in IRB approach. Institutions ‘A’ and ‘B’ share the same type of clients ;
- Extension of IRB approach to subsidiaries or branches : the subsidiary / branch would rely on or replicate existing approved IRB models / existing processes. This could in particular be the case when developing/forming new activities ;
- Merging two subsidiaries from the same jurisdiction where one of the subsidiaries is in IRB approach for a specific asset class.

- Moreover, dealing with model changes, some exposures might be in standardized approach and could be extended to IRB through a new model covering existing IRB models. Therefore, a lighter process should be applied. For the cases listed, experience-test requirements as stated in article 145 of CRR should not apply if institutions rely intensively on existing IRB framework.

9. Data Quality

The general framework is considered as very burdensome. The level of reporting (board) is considered inappropriate. Besides we suggest more alignment with BCBS 239 requirements to ensure a consistent implementation of data quality standards.

10. Third party involvement

Dealing with chapter 10.2.1 « Internal audit », clarification of the term « review » should be done (Article 49). Our understanding is that in respect of article 191 of CRR, an annual review shall be conducted either by internal audit or another comparable independent auditing unit. Regarding internal audit, general practices are to conduct annual risk assessment in order to define the appropriate internal audit work plan. Following on from this latter, “deep dives” thus internal reviews, being understood as on-site missions, could therefore be undertaken, as prescribed in articles 50 and 51.

Tackling with general requirements regarding internal audit, they should be implemented in a timely manner, considering existing framework, complexity and size of the institution.

CREDIT RISK

Dealing with PD and LGD estimation and the treatment of defaulted assets, we request to take into account answers from the industry to the EBA Guidelines on this matter and to align the guide to these EBA Guidelines once they are in place.

2. Data requirements

Paragraph 9(b) : Given that recovery costs are added to the loss, and as restructuring fees and additional late interests requested from the borrower (equivalent to penalties) with the aim of covering recovery costs (such as the costs of teams working on the restructuring), these restructuring fees and late interests should not also be included in the EAD. This would be a double counting of recovery costs.

Paragraph 11 : Institutions are asked to verify regularly the performance and robustness of external rating methodologies. As stated by its regulator ESMA[2], Credit Rating Agencies (CRA) are submitted among others to the following requirements regarding validation of methodologies especially when quantitive analysis is limited :

- A CRA should establish itself the minimum number of ratings and / or defaults that a methodology should have in order to be validated ;
- A CRA could create (if possible) hypothetical transactions that can be used to expand the available data ;
- CRA should consider relevant techniques such as the use of a 'relaxed' default definition for the purposes of validation.

We suggest to ensure a level-playing field regarding requirements applied to internal models designed by banks with rating methodologies designed by Credit Rating Agencies. This could be generalized for all types of external methodologies.

3. Probability of default (PD)

Paragraph 17 : The performance of models should be assessed on the full range of application of rating systems. Assessing the performance on sub-ranges of application could lead to hasty conclusions as the portfolio used in the calibration will not be replicated on the backtesting exercises.

Paragraph 25 : Clarification of the requirement "evidenced by records of the time series of realized default rates or loss rates for grades or pools under different economic conditions" should be done. We also do not understand why reference to loss rates for grades is introduced for requirements which tackle PD estimation.

Paragraph 26 : The term "transaction loss characterics" should be clarified.

[2] Please refer to the publication of ESMA in March 2017 : "Guidelines on the validation and review of Credit Rating Agencies' methodologies".

4. Loss Given Default (LGD)

Dealing with downturn estimation on LGDs, we suggest to take into account answers from the industry when the consultation process on the RTS EBA on downturn estimation is over.

Paragraph 40: Reference is made to the EBA Consultative Paper on guidelines on PD and LGD estimation and the treatment of defaulted assets (§90): it specifies the way the multiple defaults should be counted on the LGD side. It should remain consistent with the way the multiple defaults should be counted on the PD side, which is not explicitely mentioned.

Paragraph 42 : Even if the proposal of using a single annual discounting rate is simple and precise, it will introduce an additional unnecessary complexity in the institutions and constitute a bone of contention amid the industry and even among entities belonging to a same banking group.

For example, on a financing for a corporate, regarding the discount rate to be used for the calculation of historical LGD, if a rate much higher than the contractual loan rate is used, it creates losses even though the borrower would fully repay principal and interests. This bias would imply an overstated LGD. This bias would in turn have unintended negative consequences on the economy: the overstated LGD would imply increases in loan margins, and thus in the cost of financing for borrowers and finally on the prices for end users of products produced by such corporates.

Therefore we consider that a contractual fixed rate is the best estimate of the discount rate :

- It implies no bias: full repayment of principal and interests implies a 0% LGD (recovery costs put apart).
- It is an homogeneous rule among banks.

Paragraph 45 : Given that recovery costs are added to the loss, and as restructuring fees and additional late interests requested from the borrower (equivalent to penalties) with the aim of covering recovery costs (such as the costs of teams working on the restructuring), these restructuring fees and late interests should not also be included in the EAD. This would be a double counting of recovery costs.

Paragraph 49 : We would be interested in an explanation of what a bias introduced in the risk differentiation when combining different components could be.

Paragraph 51 : Cases where realised LGDs are under 0 may exist where recoveries exceed write-offs. Therefore, a negative floor reflects economic reality and favours accurate estimation of LGDs. Any conservatism should only be taken into account through margins of conservatism (as specified in the Guide for TRIM).

Paragraph 76 : We consider that any downturn conditions should be taken into account in the LGD-in-default or as a UL component and not in the direct estimation of ELBE.

Paragraph 78 : In order to avoid maintaining multiple unnecessary systems, provisioning models used under IFRS9 should be allowed to be used for the purposes of estimating ELBE, without these models having to satisfy different CRR requirements. Provisions are already heavily scrutinised by auditors prior to public disclosure.

5. CCF estimation

Paragraph 86 : The CRR currently gives no formal regulatory definition of a "commitment". The definition proposed in the TRIM Guide refers to the BCBS Consultative Document.

Reducing variation in credit risk-weighted assets – constraints on the use of internal model approaches (March 2016). As there is not yet any formal validation of this text which is also strongly challenged, it is considered inappropriate to mention this proposal.

Paragraph 87 : We do not understand why institutions should lead quantitative analysis or “backtest” forfeit regulatory parameter values in order to demonstrate that regulatory values are accurate.

Paragraph 93 : Application of the requirements is considered as burdensome and inefficient. Current existing IT systems do not allow such detailed tracking of product customer mix. Bias related to data are already taken into account through margins of conservatism.

6. Model-related margin of conservatism

We favour EBA's distinction between adjustments (which may be positive or negative) and the margin of conservatism - MoC (which may be zero or positive).Therefore, isolating and quantifying the margin of conservatism must enable institutions that meet all the preconditions to lift this margin of conservatism.

We understand that « institutions should provide for a customable IT implementation solution, which ensures that MoC can be implemented in a timely manner”. It would be very burdensome to upgrade all IT implementation systems to be able to parameterize each 4 MoCs from categories A to D for each model / pool. In respect of the requirement, IT implementation systems may already allow to implement in a timely manner, global new parameter values (resulting for instance from updated MoCs).

Paragraph 101 : Our understanding is that sum of MoC stemming from the four categories is above zero. In particular, MoC from category C is above zero while a zero value could be applied to MoC from other categories upon adequate justification.

7. Review of estimates

Paragraph 103 : The analysis of data representativeness as refered to paragraph 200 of the EBA GL only makes sense when performed by comparing defaulted contracts (i.e. modelled versus recently observed) and not the reference data set used for modelling purposes (composed of defaulted contracts) to the current portfolio (performing, non-defaulted assets).

MARKET RISK

We caution the ECB not to pre-empt regulatory texts still not endorsed yet for application in Europe and still subject to discussions, namely the BCBS Fundamental Review of the Trading Book. Expectations have to be grounded on final requirements set out by the EU with specified implementation date for European institutions.

3. Regulatory back-testing of VaR models

Paragraph 73 : We would like to highlight the inconsistency that the requirement in paragraph 73 would cause. Including issuer default losses in any of the back-tested P&Ls that determines the VaR multiplier may have unintended consequences. As VaR is not supposed to capture issuer default losses, which is the objective of the IRC and CRM measures, including issuer default losses in any of the back-tested P&Ls for VaR may unreasonably impose a VaR multiplier increase, which may have unintended consequences especially for distressed bond trading. Accordingly, we propose to delete the last sentence of this paragraph: "However,...included".

Paragraph 78 : Overall comment for calculation of hypothetical P&Ls for regulatory back-testing of VaR models: general principle should be set out that hypothetical P&L should be calculated consistently with the backtested VaR (as highlighted in paragraph 78 for theta effect). Effects included or excluded from VaR should be included or excluded accordingly in the related hypothetical P&L used for VaR.

COUNTERPARTY RISK

2. Trade coverage

Paragraph 17 : It is unclear whether the criteria (b) applies to either absolute price value or absolute difference of prices, in particular compared with the previous criterion. Clarification with respect to this point is needed.

Moreover, given the definition of notional is not always given for granted (ex. for complex and structured products), the test (b) may not always be straightforward. Hence the metric of test (b) shall be made adaptable to specific cases (e.g. for structured products, the notional and thus Mark to Market discrepancies can be considered at a leg level). Additionally, if we understand that inability to price sufficiently accurately products in the IMM may render those uneligible for being simulated in the IMM, other options than carve-out shall be granted. Specifically, validated fall-back solutions [paragraphs 9(c) and 9(d)] shall still be possible for those transactions that met tests (a) and (b) of paragraph 17.

Furthermore, the wording and the link between paragraphs (a) and (b) is not clear. It is not precised whether both criteria (a) and (b) are cumulative or not. The criteria could generate carve-out situations even when price differences are low and IMM pricers sufficiently accurate. This may typically happen when:

- Front Office prices are close to zero due to the test (a)
- The instrument price is high, for example deep in the money options, due to test (b)

We suggest considering that requirements of paragraphs (a) and (b) are cumulative, i.e. only when both tests are met should IMM simulated EE be discarded.

Finally and concerning the very last sub paragraph, the assymetric inclusion of pricing discrepancies (when exposures are likely to be understated) between iMM and FO/accounting could turn into excessive exposure impacts, especially regarding the selected criteria to manage price gaps. We consider that such conservative approach is unecessary given that pricing inaccuracies are generally experienced in two ways and do not generate bias on the exposures. Then our first proposal would be not to make any adjusmtent to future exposure. Alternatively and to avoid undue conservative impacts, both under and over estimations shall be accounted for. In addition, pricing discrepancies shall not be considered for margined netting sets when real collateral is used at t0 (spot) computation date, given that the discrepancies are already taken into account (and maintained throughout the first year via the "effectivization" effect) as the difference between iMM prices and real collateral deriving from FO/accounting prices.

Paragraph 18 : When applied at a portfolio level, instructions (a) and (b) could involve massive testing and computational efforts, introducing materiality issues when trying to compute iMM exposures using FO/Accounting pricing functions.

We consider that:

- such verifications should only be part of the initial validation process

- sensitivities discrepancies analysis are an overkill where CRR requirements (Article 294.1.e) with respect to initial validation of pricing functions already include testing in various market configurations

3. Margin period of risk and cash flows

Paragraphs 24 and 25 : Introducing some consistency between the DMP and the modeling of CF during the MPOR is welcome. However, we do not think that including exposures spikes generated by such CF in the effective measure adequately captures this risk.

Indeed, extra-exposure driven by CF paid to the counterparties computed by this method would be mainly sensitive to the timing of the payment and not the length of the period at risk. As a consequence, we propose that option (a) proposed in paragraph 25 be removed. In particular, any assessment of the materiality of discrepancies between the DMP and the CF modelling, as proposed in paragraph 24, should be done through the measure proposed by the option (b) of paragraph 25 (or an equivalent measure taking into account the length of the period at risk with respect to paid cash flows).

In addition, we suggest that on top of the DMP, all safeguards in place aiming at mitigating settlement risk (such as the use of CLS on FX swaps for instance) be taken into account when assessing the impact of this risk on counterparty risk exposures.

Paragraph 28 : For the same reasons than above, we propose to remove the obligation to perform impact calculations based on variant (a) of paragraph 25.

6. Maturity

Paragraph 49 : This paragraph does not cover all cases and sometimes lacks clarity. For instance:

In 49(d): The conditions of applicability of CRR Article 162 paragraph 2(i) are not fully specified. In particular, it should be made clear that is applicable only when there is a CVA Capital charge.

For netting sets in iMM where all trades have below 1 year maturity, the ECB guide stays silent. It should be clarified that for those, is applicable the relevant paragraph 2(a) to 2(f) of CRR Article 162.

Paragraph 50 : The ECB guide proposes not to account for contractual arrangement that allows the institution to terminate a transaction (open repo, ETC). It is our view that contractual arrangements shall be reflected in the exposure amount determination.

For open repos, that means that they should be considered of 1 business day maturity. If the ECB was to continue considering that open repos have longer maturities, we would suggest not to overburden the framework as proposed at paragraph 50(a), a simple 5 business days supervisory maturity should be sufficient.

7. Granularity, number of time steps and scenarios

Paragraph 59 : This paragraph lacks precision in the test definition. We understand that this article refers to Monte Carlo error but it needs to be confirmed. Could paragraph 59 better specify the test?

8. Calibration frequency and stress calibration

Paragraph 67 : The ECB suggests that the calibration of the internal risk measurement (stochastic parameters & correlations) shall be made on a monthly basis. This requirement goes beyond the level 1 text [CRR Article 289 Paragraph 2] which requires only quarterly calibration (and more often only when deemed necessary due to significant changes in market conditions). We therefore suggest that the guide shall align itself to the CRR.

In addition, for banks using historical calibration methodologies, a quarterly recalibration is seen as sufficient. Indeed, information added for one additional month over a three years calibration window is likely to be unsignificant.

9. Relevent regulatory references

Paragraph 77 : The sample to be back-tested is required to be representative as well as having a sufficient coverage. Are those two terms intended to mean the same thing?

Also, a coverage ratio of 50% may not be reachable on all metrics and added flexibility shall be granted in the determination of a sufficient coverage ratio.

Paragraph 79 : Regarding (a), we wonder what the interpretation and the analysis added-value of exposure gaps between the use of risk or FO pricing shall be, in particular when we already accept (cf article 17) that pricing discrepancies can be worth 10% of notional. Point (b) is not clear enough in its current wording and shall be precised further in its intention and operational application.

Paragraph 81 : It is expected to confirm that the backtesting of margined net exposure would involve comparing realized net exposure (i.e. with actual PV minus collateral at t) versus diffused net exposures (i.e. with diffused PV minus theoretical collateral computed as the portfolio PV at the beginnning of MPOR). If confirmed, we are unsure of how relevant the outcomes of this test would be as one would compare:

> (1) projected PV diffusion during the MPOR purely generated by the diffusion process over the MPOR with

(2) spot discrepancies embeding exogeneous effects (disputes, discontinuous effects linked to thresholds and MTAs...) rather than a pure diffusion effect that would be supposed to be lower anyway for non yet defaulted counterparties.

11. Alpha parameter

Paragraph 88 : This paragraph states that the alpha is among other things to "address general model deficiencies". This objective is not mentioned in the CRR or the Basel text. If the alpha may be increased, on a case by case basis, to cope for a perceived model deficiency, its supervisory value of 1.4 is not to cover across the board model deficiencies in modelling CCR exposures.