Statement on the application of CRR 3 in the area of credit risk for the Internal Ratings Based Approach

The EBA welcomes the entry into force of the new European Banking Package1, which implements the final Basel III Accord into the EU regulation. The new framework enhances the risk sensitivity of the Standardised Approaches and puts in place adequate safeguards to internal modelling to reduce undue variability of model outcomes. The benefits of a resilient banking sector were highlighted during the recent COVID-19 and energy crisis, where banks ensured a continued support to the economy.

In order to ensure a smooth operational implementation of the Banking Package, the EBA encourages institutions and competent authorities to engage in an active dialogue. Considering the strategic relevance of the targeted model landscape, institutions are in particular expected to communicate to their competent authorities the targeted model landscape that will be used from January 1, 2025 onwards. This includes a discussion on whether the IRB Approach is to be used for each of the exposure classes as defined in Article 147(2) of CRR 3, and more particularly on:

- The rating systems to be used for the exposures of each exposure class;
- The permanent partial use and roll out plans and possible updates for which the permission from Competent Authorities is to be sought according to Articles 148 and 150 of CRR 3;
- The use of the possibility to return to less sophisticated approaches offered by Articles 149 of CRR 3 for a type of exposure or exposure class, for which the permission from Competent Authorities is to be sought, and by Article 494d of CRR 3 for one or more exposure classes for which a notification to Competent Authorities is to be sent six months before it effectively does revert to that approach;
- The implementation plan related to the mandatory reversal to less sophisticated approaches according to Articles 150(1)(a), 151(8), 151(9), 495 and 495a(3) of CRR 3, as well as the implementation of the new requirements related to credit risk mitigation as specified in Articles 108, 235a and 236a of CRR 3. This should include at least the date(s) at which the review of estimates, to be performed in accordance with Article 179(1)(c) of CRR 3, of the models impacted by this reduction of range of application will be finalised.

In this context, for each of the rating systems impacted by a reduction of their range of application, either due to a migration of exposures to less sophisticated approaches or due to a modification of the assignment of exposures to exposure classes, an ex-ante notification should be sent to the

Competent Authority, in accordance with Commission Delegated Regulation (EU) No 529/2014 (CDR on materiality of changes to the IRB Approach). In addition:

- For all rating systems, the EBA considers that it is a good practice for institutions to adequately analyse, as part of the regular review of estimates, the representativeness, model performance and appropriate level of calibration of the estimates on the future range of application of the rating system and ensure adequate remediation in case this cannot be demonstrated;
- For material and complex rating systems subject to a material reduction of their range of application, institutions are expected to anticipate the review of estimates of Article 179(1)(c) of CRR 3 in order to verify the adequate performance as defined in Article 144(1)(a) of CRR 3 of the rating system on its future range of application;
- In both cases, if the performance of the rating system on the new range of application is not satisfactory and requires some changes to the rating system, the materiality of these changes should be assessed according to the CDR on materiality of changes to the IRB Approach.

Furthermore, institutions are required to assess and categorise any other changes coming from the implementation of the CRR3 that impact the performance of a rating system according to the CDR on materiality of changes to the IRB Approach and bundle them for permission or notification. The prioritisation of the implementation of these model changes and any related remediation plans and actions, including possible temporary mitigation measures, should be discussed with the competent authority.

On the other hand, the EBA considers that mandatory changes coming from the implementation of the CRR 3 and that do not impact the performance of a rating system should not be considered under the scope of the CDR on materiality of changes to the IRB Approach. As such, they do not require an authorisation from the Competent Authority nor a notification. These changes include the application of new regulatory values (new PD, LGD and CCF input floors, new LGD and CCF regulatory values and new parameters in the credit risk mitigation framework) and updates in relation to the risk weight function (e.g. deletion of the 1,06 factor).

In any case, the EBA believes that institutions should communicate to their Competent Authority their implementation plan about the application of CRR 3, as well as when the related changes have been successfully implemented and their impact in terms of risk weighted exposure amounts and own funds requirements. If the institution does not comply with the requirements of Chapter 3 of Title II of Part Three of CRR3, it shall notify the competent authority in accordance with Article 146 of CRR 3.

Last, the EBA believes that institutions should inform their competent authorities about their implementation plan in relation to the foreseen rating system updates that are linked to future EBA supervisory products (cf. CRR 3 mandates for EBA). In particular:

- The EBA considers that, with respect to the CRR 3 changes on credit conversion factor estimates (IRB-CCF), institutions shall implement the changes impacting the scope of application of the IRB-CCF (limitation to revolving commitments as per Article 166(8b) of
CRR 3) and the final IRB-CCF (CCF input floors) at the application date of CRR 3. The implementation of other CRR 3 changes on IRB-CCF which may impact the performance of the rating system (e.g. 12 months fixed horizon reference date) may not need to be prioritised until the finalisation of the EBA guidelines specifying the methodology that institutions are to apply in order to estimate IRB-CCF, as mandated by Article 182(5) of CRR 3. For these other CRR 3 changes, institutions should assess the materiality of the temporary non-compliance to CRR 3 and discuss with the Competent Authority about the application of adequate mitigation measures to their IRB-CCF until the changes are implemented;

- Similarly, the EBA encourages institutions not to update their definition of default that are linked to future EBA supervisory products before the finalisation of the possible revisions to the guidelines on the definition of default, as mandated by Article 178(7) of CRR 3.