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## Answer from EURO CRO Group to EBA consultation on the RTS for assessing the materiality of extensions and changes of the IRB approach

Dear Sir or Madam,

Since the beginning of the supervisory exercise Targeted Review of Internal Models (TRIM) in 2016, European banks have indulged in structural revamping of their IRB models according to the “IRB Repair” requirements set by the EBA. Strong investment in large projects was made by banks and significant progress took place benefitting all European Banks. **In the continuous improvement of IRB framework, it remains essential that banks maintain transparency and continuous communication with their supervisors of their planned model changes. Commission Delegated Regulation 529/2014 has been for years the only base to provide common rules for banks to classify their IRB model changes.** In the context of CRR3, proposed amendments to this regulation made by the current EBA consultation raise concerns among CROs from European banks as consequences of material model changes may impact the whole chain of the credit rating process and more generally the risk framework.

In this context, **the EURO CRO Group representing a large panel of European banks would like to seize the opportunity to provide its answer to the EBA consultation on the RTS for assessing the materiality of extensions and changes of the IRB approach.** We understand that the EBA has maintained both quantitative and qualitative criteria in the decision framework for model change classification. Although there are some welcome simplifications in the EBA consultation paper, newly introduced features do not significantly alleviate the burden for both banks and supervisors as numerous model changes would continue to be classified as material.

### The main areas of concern for the EURO CRO Group regarding the new RTS are the following:

- From a larger perspective, the decision for a material change should be simplified to leave **supervisory discretions** preventing an overly mechanical decision to material classification. On the one hand, a judgemental layer left to banks and supervisors should make possible a reclassification from material to non-material change. On the other hand, more frequent classification to ex-ante notifications instead of material changes could be achieved by relying less on both quantitative and qualitative criteria.

- A **refinement of the scope** is needed when looking at the Recital detailing the possible cases for inclusion in the RTS. In the light of further development of machine learning techniques by banks, frequent recalibration should be facilitated by notifying the supervisor after implementation. In the same vein, clarity in the Recital is expected regarding the extensions of existing IRBA rating systems to additional exposures initially treated in STD/FIRB approach to avoid systematic categorisation in material changes in the implementation of roll-out plan.
- For the classification of **changes to the definition of default**, stronger reliance on metrics assessing if the range of application of rating systems is modified in a significant manner (e.g. impacted volumetry of default) would be welcome.
- In line with the CRR mandate given to EBA regarding this RTS, we propose to **exclude changes to assignment of exposure classes from the scope of the RTS**.
- We would encourage simplified model changes when **introducing ESG risk drivers**, which could be materialized by the introduction of an arrangement allowing the mandatory classification as ex-ante notifications for a transitory period.
- **Issues regarding the new assumptions introduced in the framework:** analysis of rank ordering / distribution of obligors on final risk parameters, new ratio introduced for extensions of models etc.

Detailed answers to the questions underlined by the EBA could be found in the joined detailed document. **To foster better synergy in the reflection between the EBA and banks, the EURO CRO Group would look forward for a meeting with the EBA in order to further discuss our proposals and explore together possible solutions.**

Yours sincerely,

## The EURO CRO Group

José Luis Elechiguerra  
BBVA

Frank Roncey  
BNP Paribas

Franck Leroy  
Groupe BPCE

Bernhard Spalt  
Commerzbank

Alexandra Boleslawski  
Crédit Agricole

Olivier Vigneron  
Deutsche Bank

Ljiljana Čortan  
ING

Davide Alfonsi  
Intesa Sanpaolo

Mark Kandborg  
Nordea

Mahesh Aditya  
Grupo Santander

Stéphane Landon  
Société Générale

TJ Lim  
UniCredit Group

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## Answer from EURO CRO Group to EBA consultation on the RTS for assessing the materiality of extensions and changes of the IRB approach

Commission Delegated Regulation 529/2014 developed years ago provides guidance for banks in their supervisory dialogue whenever they plan to change features of their IRB framework, e.g. aspects of the underlying models or platforms. Based on the experience from banks, the level of involvement for both banks and supervisors highly depends on the categorization of the model change which could constitute a material or non-material change.

For banks supervised by the SSM, whenever a material change is triggered, it systematically leads to an Internal Model Investigation (IMI) mission. As clearly underlined in the ECB Guide on On-Site Inspections and Internal Model Investigations, different steps are mandatory in an IMI such as for instance the on-site fieldwork phase and exchanges between audit teams and supervised entities, submission of draft report and right to be heard, horizontal review by ECB transversal teams, emission of final report and decision letter. **Considering all phases around such IMI, the whole process can last several years until supervisory approval is given in a decision letter, without which implementation by banks of the changes cannot be done.**

Among others, resources invested by banks and supervisors are significant in the case of an IMI. When several IMI are needed at the same time because of material changes to be treated in the same timeframe, necessary staggering is endorsed by the ECB which could spread the process over time. The duration of such process for material changes may be deterrent for timely implementation of changes which aim to improve the IRB framework. As a side note, we plan to send to the ECB a letter explaining our concerns regarding the complexities resulting from long timelines for model approval.

The EBA, in collaboration with competent authorities has explored the option of combining qualitative and quantitative criteria to trigger a material model change. While EBA's preliminary conclusion at this stage is that qualitative triggers should be maintained on a standalone basis, we find this option overall very relevant.

As a general message, we wish to emphasise our general preference for this approach, which in our view may be further enhanced by incorporating the **idea of flexibility granted to competent authorities for the requalification of the model changes**, as follows:

- If both qualitative and quantitative criteria for material change are met, the change should be considered material. However, a judgmental layer may apply at the end of the process which allows to change the classification from material to non-material categorization. This judgmental reclassification could be a flexibility left for both parties (banks and JST/CA), which can be justified based on the stakes for the bank and could be in the first place proposed by the bank. Experience shows that in some cases, supervisors are bound by CDR 529/2014 to decide for material change even if their judgement would have concluded to a non-material change.
- If only one of the two criteria is met, an ex-ante notification shall be made by the supervised institution, allowing the JST/CA to analyse the information provided, request additional information if necessary, and ultimately determine whether the qualification of the model change should be elevated to ‘material’, under a risk-based, prudent but proportionate approach.
- For any changes with RWA reduction of less than 5% at the range of application level or RWA decrease of less than 1.5% at Group level, they would be subject to ex-ante notifications, unless they enter the ex-post notification categorization.

These supervisory discretions would prevent an overly mechanical approach to material classification - which may generate unintended burden for supervisors and institutions, thereby supporting the objective of simplification pursued in the update of CDR 529/2014, as indicated in the recital (5) of the draft RTS subject to consultation.

The following chart illustrates in definitive the possible cases for material changes and ex-ante notifications:

	Quantitative criteria (RWA impact)			
Type of qualitative criteria triggered?	RWA decrease at Group level > 1.5%	RWA decrease (range of application) greater than 15%	5% < RWA decrease (range of application) < 15%	Other (RWA decrease at range of application level < 5% or at Group level < 1.5%)
Material criteria	Material change (could be modified by JST/CA)		Ex ante notification (could be modified by JST/CA)	
Non-material criteria	Ex ante notification (could be modified by JST/CA)		Ex ante notification	
Other			Ex-post notification	

The categorization for ex-post notifications will remain unchanged, except for the few proposed amendments made in answers to following questions (cf infra).

**Question 1. Do you have any comments on the clarification of the scope of the revised draft regulatory technical standards to specify the conditions for assessing the materiality of the use of an existing rating system for other additional exposures not already covered by that rating system and changes to rating systems under the IRB Approach?**

### **Refinement of the scope (Recital):**

From a general perspective, positions in the proposed RTS are consistent in the EBA “Statement on the application of CRR3 in the area of credit risk for the Internal Ratings Based Approach”. Indeed, we understand that EBA mandate, according to article 143(5) of CRR, is to write “*standards to specify the conditions for assessing the materiality of the use of an existing rating system for **other additional exposures not already covered by that rating system and changes to rating systems under the IRB Approach***”. In particular, the following changes which do not concern rating systems are therefore outside of the scope of the RTS: change of the regulatory fixed values for risk parameters (e.g.: changes to F-IRB values), changes to STD approach, implementation of input floors etc...We welcome the additional precisions provided to further define the scope of application of this regulatory product, although with respect to newly added Recital (2) better clarifications (including examples if possible) on the “*updates to the data used in the ongoing application of the rating systems in order to calculate the risk weight exposure amount for the application portfolio*” would be helpful considering that one type of “updates to the data” remains within the scope of the RTS while the other one is outside.

The current wording of Recital (2) may have some unintended consequences. We think that recalibration after backtesting or update of risk drivers only as a mechanical effect of adding one additional year of default should deserve lighter treatment to avoid burden for both banks and supervisors. From a larger perspective, a general point of clarification would be related to changes/model novelties related to Machine Learning components possibly nested into internal models’ structures to enhance their performance. Such technicalities tend to be characterized by high frequency of reparameterizations that appears not fitting under both the current and new RTS. Under this vein, it appears necessary to get full clarity on how to cope with these technicalities and this CDR 529/2014 revision shall be an opportunity to qualify the regulatory requirements on this topic, duly considering the related peculiarities. Should the Recital (2) be left unchanged, such recital could deter the use of such techniques. **Thus, we propose to alleviate the burden by considering that a mechanical recalibration following regular updates of data, without any rebuilding of the model, should be subject to an ex-post notification.**

In addition, we believe that it would be relevant to clarify that the remediation of data quality issues (e.g. amending missing/incorrect LTV input data or fixing data traceability issues), even if they affect the modelling process, should not constitute an IRB change. Indeed, given that such changes improve the framework and represent low stakes, we suggest excluding such changes from the scope of the RTS.

As a conclusion, we propose to modify the Recital (2) in the following way:

Initial text	Proposal for amended text
<p>(2) (...) Updates to the data used in the development and calibration of the rating systems should therefore be covered by this Regulation. However, updates to the data used in the ongoing application of the rating systems in order to calculate the risk weight exposure amount for the application portfolio should not be covered by this Regulation.</p>	<p>(2) (...) Updates to the data used in the development and calibration of the rating systems should therefore be covered by this Regulation. However, updates to the data used in the ongoing application of the rating systems in order to calculate the risk weight exposure amount for the application portfolio should not be covered by this Regulation. <u>In the case of mechanical recalibrations following regular updates of data, such changes could be subject to ex-post notifications. In addition, changes to remediate data quality issues (e.g. amending missing/incorrect LTV input data) in order to improve the modelling framework are not covered by this Regulation.</u></p>

As an alternative proposition, it could be stated that if during the validation/authorization phase of the model the supervisor has accepted/foreseen the use of continuous updating mechanisms as a core element of the authorized machine learning model, the update of these mechanisms does not trigger a material model change.

**Inclusion of ESG risk drivers:**

Regarding the inclusion of relevant ESG risk drivers in IRB models, we understand from the public hearing that they would be in the scope of the RTS. In this case, the related changes could trigger “changes to rating criteria”, which lead either in a material change or an ex-ante notification, unless other material criteria are triggered. As such inclusion will probably be implemented across European banks within the same timeframe, all banks will submit their model changes during this same period, creating congestion in the supervisory approval process which can lengthen the process. In order to provide virtuous incentives, **we encourage the regulator to fast-track this process by considering a transitional arrangement up until a certain reasonable date (e.g. regulatory deadline to include ESG risk drivers in Pillar I models) where banks could by way of derogation submit ex-ante notifications to include ESG risk drivers in their models** (without having to perform any analysis on the rank ordering or distributions of obligors). It would accelerate implementing actions for banks, while alleviating the burden of review for supervisors. After this certain date, the usual rules described in the RTS would apply. In the perspective of a more general revisit of the criteria when the RTS is applied as usual, Annex I, Part II, Section 1, point 2(a), point 2(f) and point 2(g) should be softened so that simple model maintenance activities like **replacing risk factors, adding (e.g. ESG-related) risk factors or increasing the list of eligible collateral types which do not affect the overall structure of a model should only require ex-ante notification.**

## **Other concerns:**

The EBA is capitalizing on its statement made on CRR3, which details the need for model change submission based on whether the changes impact the performance of the models or not. In this context, the RTS should state permanently that changes imposed by regulation which do not affect the performance of the rating systems are out of scope. For instance, a LGD model whose scope is totally aligned with Institutions exposure class is out of scope because of the mandatory application of FIRB LGD in CRR3. For consideration of similar changes in future regulations, such stance should be applied permanently.

Finally, because of the new RTS, institutions will need to adapt their internal policies on IRB changes management. To avoid an excessive regulatory burden, we suggest clarifying that the adaptation of institutions' internal policies to transpose this regulation should fall outside the scope of this RTS.

**Question 2. Do you have any comments on the clarifications and revisions made to the qualitative criteria for assessing the materiality of changes as described in the Annex I, part II, Section 1 and Annex I, part II, Section 2? (changes to rating systems)**

## **Changes to definition of default:**

Regarding changes to the definition of default, we welcome the EBA initiative to introduce better separation between changes which entail a material change and the other changes where ex-ante notifications are needed. In the proposed RTS, the following cases are listed as material:

- *they change the method to identify if the obligor is more than 90 days past due on any material credit obligation*
- *they change the level of application of the definition of default for retail exposures*
- *they change the use of external data*
- *they change whether an indication of unlikelihood to pay results in an automatic or in a manual default reclassification*
- *they change the default classification in the reference dataset or scope of application of a rating system in a significant manner, the measure and level of which will have been defined by the institution*

Dealing with the newly introduced criteria, we would like to share several comments:

- We understand from the public hearing that the EBA would encompass in the “material” category an extensive range of changes to definition of default related mostly to operational implementation issues. Not only may these changes not impact rating systems, but such changes do not prevent the well-functioning of risk management functions. For instance, in a change of the batch frequency for defaulting exposures from monthly to daily (with exact date and number of days being stored in any case), the impact is only on the frequency at which the new defaults are stored in the systems. Such change not only is an improvement of the framework but also does not modify the result of the identification of default and does not impact the rating systems.

- In addition, some new requirements remain vague regarding “changes whether an indication of Unlikelihood to Pay results in an automatic or in a manual default reclassification”. Although it appears clear from the EBA position that modifying an UTP default event trigger from automatic to manual reclassification generate a material change, we understand that changes from manual to automatic reclassification rather than changes in general to UTP triggers shall be notified a minima as ex-ante notifications. In practice, the UTP detection starts from the elementary early warning signals underlying the Portfolio Credit Monitoring process. The system of EWS strictly pertains to the credit operations of the banks and is subject to ongoing updates and fine-tuning thus requiring timeliness in the execution. Because of unclear boundaries of this requirement included in the new RTS, there can be a risk of introducing severe slowdown to credit operations if an ex-ante notification is foreseen also for changes introduced at the level of elementary indicators in the EWS (that may have, even if indirectly, an impact on the default detection). This point deserves further attention and clarifications when defining the boundaries of the application perimeter of the RTS: our opinion is that process changes pertaining exclusively to the credit operations at the level of the elementary indicators of the Early Warning System should not be in the scope of this RTS; only changes in the rules and methodologies of default detection shall be covered by the RTS.
- The classification criteria for a change in definition of default is considered as stand-alone compared to the related impact that would stem for internal models (that will be capture with other criteria of the RTS). In this regard it is interesting to note that no impact on RW for non-defaulted assets is expected from the change of the definition of default (“*It is also noted that a change of the definition of default alone does not change the risk weighting of non-defaulted exposures*”). However, it has to be considered that the change in the default classification criteria would be prone to change the asset quality composition (i.e. performing/default composition), as such the pure migration from performing to default due to the changed classification policy is prone to generate an RWA impact due to the pure shift from one bucket to another. However, the RWA impact for changes in the definition of default are in the end purely related to the portfolio shift due to changed default criteria without any impact on the internal models (being this latter covered by other criteria of the RTS). Clarifications in this sense are of particular importance from the operational and execution standpoint considering the experience gained in the context of the material model changes carried out during the IRB Repair Program to adhere to the EBA-GL-2016-07 (where the impact on internal models were required). In this perspective, the most objective way to assess the impact would be to rely on quantitative metrics (e.g.: impacted default volumetry which could easier to assess than RWA impact). As an illustrative example, the change of an existing UTP trigger which was leading systematic to default into a trigger which is assessed on case-by-case basis (other indication of UTP) leads to an impact of only few defaults, thus having nearly no impact on risk parameters. Such example of change is not material. This is why we would introduce a distinction between changes with an impact on ratings systems and changes with no impact on rating systems. In this sense, the subparagraph (e) of the point 3 of Annex I, Part I, Section 1 could be enough to capture the materiality of the change.

Considering all our of our concerns, we therefore propose the following amendment of the RTS (Annex I, Part I, Section 1):

Initial text	Proposal for amended text
<p>3. <i>Changes in the definition of default according to Article 178 of Regulation (EU) No 575/2013, if any of the following conditions are met:</i></p> <p>(a) <i>they change the method to identify if the obligor is more than 90 days past due on any material credit obligation according to Article 178(1)(b) of Regulation (EU) No 575/2013;</i></p> <p>(b) <i>they change the level of application of the definition of default for retail exposures according to Article 178(1), second subparagraph of Regulation (EU) No 575/2013;</i></p> <p>(c) <i>they change the use of external data according to Article 178(4) of Regulation (EU) No 575/2013;</i></p> <p>(d) <i>they change whether an indication of unlikelihood to pay according to Article 178(3) of Regulation (EU) No 575/2013 results in an automatic or in a manual default reclassification;</i></p> <p>(e) <i>they change the default classification in the reference dataset or scope of application of a rating system in a significant manner, the measure and level of which will have been defined by the institution.</i></p>	<p>3. <i>Changes in the methodologies and rules to the definition of default according to Article 178 of Regulation (EU) No 575/2013, if <del>any of the following conditions are met:</del></i></p> <p><del>(a) they change the method to identify if the obligor is more than 90 days past due on any material credit obligation according to Article 178(1)(b) of Regulation (EU) No 575/2013;</del></p> <p><del>(b) (a) they change the level of application of the definition of default for retail exposures according to Article 178(1), second subparagraph of Regulation (EU) No 575/2013;</del></p> <p><del>(c) they change the use of external data according to Article 178(4) of Regulation (EU) No 575/2013;</del></p> <p><del>(d) they change whether an indication of unlikelihood to pay according to Article 178(3) of Regulation (EU) No 575/2013 results in an automatic or in a manual default reclassification;</del></p> <p><del>(e) (b) they change the default classification in the reference dataset or scope of application of a rating system in a significant manner, the measure and level of which will have been defined by the institution. <u>Institutions could define such metrics for instance on the relative impacted volumetry of default.</u></del></p>

In addition to this amendment, Article 4 of the RTS which relates to the calculation of quantitative criteria (RWA impact) should be modified in order to delete the quantitative criteria when changes to the definition of default are concerned (in order to rely uniquely on the quantitative measure regarding the change in the RDS or scope of application of a rating system in significant manner).

**Changes to validation methodology / process:**

Regarding changes to validation methodology and process, we believe room for flexibility should be introduced in the sentence “*For example, changes to traffic light thresholds of test metrics leading to a more positive validation result are deemed a material change; however, where such changes lead to an equally strict or more conservative validation result, an ex-ante notification is deemed appropriate. For this purpose, institutions should carefully consider the impact of the change on aggregated test outcomes*

where thresholds are set at a level higher than an individual test metric.”. Our understanding is that simple changes to traffic light thresholds of test metrics which lead to a more positive validation result are deemed a material change. In practice, there could be changes in the aggregation workflow of a test executed at different levels, that should be simulated to get the direction and the classification of the change. Since the validation framework could apply to an extended number of models across a banking group, the full simulation exercise would be burdensome. For this reason, **we deem that the institution should have the possibility to sample the models to simulate, using appropriate materiality criteria, and classify the change based on the outcome on the sample.** Moreover, some little fluctuations may be possible, e.g. most of the final test outcomes are the same except for a couple, which are less severe; in this case, we deem a classification as material would be incorrect. Furthermore, the institution should have the possibility in some cases for a qualitative classification assessment, to complement the “mechanical” outcome of the simulation. For instance, if the institution introduces/reviews a materiality concept in the aggregation workflow, which penalizes less the immaterial component; per se, such an intervention is more lenient, but the final simulated outcome on the sampled models could be very marginal.

## **Changes to assignment of exposure classes:**

As expressed earlier in the document, the EBA mandate for the RTS is “to specify the conditions for assessing the materiality of the use of an existing rating system for **other additional exposures not already covered by that rating system and changes to rating systems**”. When requiring that changes to the assignment of exposure classes should be notified, the EBA therefore presumes that rating systems and exposure classes are interlinked, meaning that any change to exposure classes will impact rating systems. However, such link is not always the case in practice: institutions do not necessarily use an exposure class to define the scope of a rating system. In addition, EBA indicates in paragraph 11 of the background and rationale that “changes to aspects outside of the rating systems applicable under the IRB approach should not be considered falling within the scope of the RTS on model change”, even if they may have a potential impact on the RWEA calculation, whereas the methodology for assigning exposures to exposure classes continues to fall within the scope of the RTS on model change as changes to this methodology may also affect the internal risk estimates used for RWEA calculation and not only the formula used for RWEA calculation itself. As such the understanding is that:

- changes impacting the rating systems, in its definition set out by CRR ([...] all of the methods, processes, controls, data collection and IT systems that support the assessment of credit risk, the assignment of exposures to rating grades or pools, and the quantification of default and loss estimates that have been developed for a certain type of exposures;) shall be subject to ex-ante notification
- changes to other input parameters for the RWA formula not affecting the rating systems do not require any notification.

However, this appears in apparent contradiction with what is stated in paragraph 22 of the background and rationale quoting that “(...) changes in the methodology used for assigning exposures to different exposure classes are reclassified as requiring an ex-ante notification. Although it is noted that such a

*change may potentially affect RWEA, the change in RWEA stemming from a change in the assignment methodology would stem from applying a different prescribed RWEA formula, input floor or other regulatory prescribed input (i.e., CRR3 requirements) rather than changes to the rating systems themselves.”*. Such wording seems to state that a change in the assignment of exposure class leading to a change in the applicable RWA formula shall be always notified as ex-ante independently from the presence of an impact on rating systems. To better clarify the interpretative doubts, we provide the following example: the allocation to the exposure class Retail-QRRE, which under the new CRR3 represents an explicit new exposure class as per amended article 147, depends on a list of criteria, including the check on the volatility of loss rate. Let us assume that the analysis for the volatility of loss rate has been done fulfilling the requirement for moving from Other Retail to Retail-QRRE asset class, this change will be notified ex-ante even in a situation where underlying PD-LGD-CCF models applicable to this perimeter are completely untouched, which is counterintuitive.

In our view, only the notion of “type of exposures” is closely linked to rating systems as per definition of CRR which specifies that rating systems are developed for “a certain type of exposures”.

Thus, for all the reasons mentioned above, **we think that changes to assignment of exposure classes should be excluded from the scope of the RTS when such changes do not affect the models**. Such changes will be consistent with the EBA stance which is to exclude aspects outside the rating systems which may only affect the RWA formula.

### **Changes in relation to risk differentiation / risk quantification:**

Regarding the calculation assumptions at the level of final risk parameters when assessing the significance of i) changes in the rank ordering; ii) changes in the distribution of obligors, facilities and exposures across grade or pool, the following comments are provided:

- Given the supervisory expectation of estimating MoC at grade level (as per paragraph 208 of ECB Guide to internal models), a change in the MoC could influence rank ordering or distribution despite no change in the main structure of the model. As such the analysis should be done on the final parameter both before and after MoC. The same holds for the presence of a Supervisory Limitation operating at the level of single parameter PD-LGD-CCF and for which a model change is expected to address the related obligation. Indeed, whereas it could be understandable its consideration in the quantitative RWA criteria, for the qualitative assessment **the interference of a limitation in the assessment of the change and in the analysis of rank ordering and distribution should be avoided (being in the end a pure additional supervisory conservative measure put on top)**.
- More in general, the analysis framework defined on the final parameter shall be differentiated between changes impacting the risk differentiation (expected as more intrusive in the structure of the model) and changes in the risk quantification (e.g. resulting for example from a pure extension of the time series or changes in the pure risk quantification components like MoCs or LGD Downturn). Indeed, the inclusion of additional years in a pure recalibration (rather than a basic review of a MoC) could influence the rank ordering and rating distribution (since the parameter could increase or decrease) but without generating changes in the rating criteria / the risk differentiation features of the model. This is also clearly highlighted in Annex I - Part II - Section

1, letters d) and letters f) that clearly differentiate changes impacting the risk differentiation part (letter d)) and the risk quantification (letter f)). In the textual formulation of these two letters (even in the newly drafted amended version) it appears clear that the checks on rank ordering and rating distribution results are particularly relevant for changes in the rating criteria as referred to in Article 170(1)(c) and (e) and Article 170(4) (i.e. letter d)) rather in presence of changes for estimating PDs, LGDs including best estimate of expected loss, and conversion factors according to Articles 180, 181 and 182, thus pertaining to the risk quantification (i.e. letter f)). Therefore, and stated in any case the check on RWA quantitative impact, **banks need to have a framework that allows for an appropriate differentiation in the nature of the change (i.e. if related to risk differentiation pertaining Article 170/letter d) or to risk quantification, concerning Articles 180-181-182/letter f)) when it comes to assessing the outcomes of the rank ordering and grade/pools distribution changes.**

- Finally, a disagreement is raised with reference to the new approach defined for the rank ordering assessment for the Slotting Approach. Indeed, it represents a purely regulatory based approach with just 4 possible performing grades, as such it is definitively disproportionate to include SSCA under the ordinary framework foreseen for the other IRB models. Indeed, Specialized Lending portfolios are characterized by a limited number of observations by definition and, as such, by an inherent volatility not necessarily due to the model change itself but to the features of the portfolio snapshot considered in the specific point-in-time of the assessment. **We deem that the previous CDR 529/2014 formulation for this perimeter be appropriate to manage the specificity of SSCA.**

As mentioned in the point 2(f) from Annex I, Part II, Section 1 of the new proposed regulation, change in the fundamental methodology for estimating PD/LGD now encompasses methodology for deriving appropriate adjustments and should be considered as a material change (ex-ante notifications otherwise). For these cases, it is within the remit of the bank to define what constitutes a “change in the fundamental methodology”. In this exercise, difficulties may appear as from a supervisory perspective, this fundamental feature could not solely be based on RWA impact. Depending on the size of the exposures/models for the bank, the limit between material changes and non-material changes is objectively captured through the RWA impact, rather than through more subjective criteria determined by the bank. Thus, **the introduction of a flexibility such as described in our general messages, will facilitate the interpretation of changes in the “fundamental” methodology by the bank.**

One additional suggestion is to specify in the RTS that if the change is aimed at addressing a request from the supervisor expressed through an obligation/finding of lower severity (e.g., F1-F2 or F3) and possibly very specific, it could be managed via a notification (either ex-ante or ex-post).

Lastly, as already mentioned above, Annex I, Part II, Section 1, point 2(a), point 2(f) and point 2(g) should be softened so that simple model maintenance activities like replacing risk factors, adding (e.g. ESG-related) risk factors or increasing the list of eligible collateral types which do not affect the overall structure of a model should only require ex-ante notification. As soon as such change were to meet quantitative thresholds, they would be attributed to a material change category if applicable.

**Question 3. Do you have any comments on the clarifications and revisions made to the qualitative criteria for assessing the materiality of extensions and reductions as described in the Annex I, Part I, Section 1 and Annex I, Part I, Section 2? (*changes to the range of application of rating systems or internal models approaches to equity exposures*)**

As mentioned in Question 1, clarifications are needed on paragraph 22 in combination with paragraph 11. We would like therefore to refer to the reply to Question 1.

According to the paragraph 19 of the Background and rationale, the EBA mentions a “As such, in accordance with Article 148(1) of Regulation (EU) 2024/1623, additional exposures that were not risk weighted by another rating system (i.e. under the Standardized Approach or by F-IRB if the scope of an LGD model is extended) require in any case an approval by the competent authority and are not within scope of this RTS”. However, Article 148(1) only refers to the approval of the roll-out plan and does not concern the request for an approval of a new rating system.

Moreover, we would like to point out the issue raised by such EBA stance repercussed in Recital (3): it could be understood that exclusion of the scope of RTS now apply to the extension of an existing IRBA rating system (or existing models) to exposures treated under STD/FIRB approach, which cases were, to our understanding, within the scope of the previous RTS. In more depth, our vision of the framework is the following:

- As part of article 148(1) of CRR, banks should submit their roll-out plan for approval by the supervisor. Such roll-out plan may include the future application of IRBA to exposures treated currently in STD/FIRB approaches by extending an existing IRBA rating system. Another way to proceed could be to create a new rating system to be applied to STD exposures (or to create new LGD/CCF models to be applied to FIRB exposures)
- When implementing the roll-out plan, several situations may happen:
  - When creating a new rating system (or new model), banks will file a prior approval as per article 143(2) of CRR. We will concur with the position that such cases are indeed outside the scope of this new RTS providing technical details on articles 143(3) and 143(4) of CRR.
  - On the contrary, the extension of an existing A-IRB rating system (or existing model) to exposures previously treated under SA/F-IRB is within the scope of the CDR 529-2014: banks will assess the representativeness of the exposures before and after extension and test any applicable quantitative threshold. Such analysis will either lead to conclude to a material classification or an ex-ante notification. As a matter of fact, also in the perspective of rationalizing the model landscape, banks rather consider extending their existing rating systems when they have enough confidence that adding exposures to the range of this rating system would maintain a relative stability of the model structure, thus that these additional exposures would likely be representative of the initial exposures used to develop the existing rating. In such case, possible outcome would be an ex-ante notification. Should however a material change being triggered for every case of the roll-out plan, this would make it difficult to achieve full implementation of the plan for instance within the timeframe of 5 years recommended in the EGIM. This is why we think

that having systematic categorization for material change to treat extensions of existing rating systems to STD/FIRB exposures would be too drastic.

**The possibility to qualify the extension of an existing IRBA rating system as an ex-ante notification should therefore remain possible (based on the analysis of representativeness).** We think that this should be clarified in the RTS

#### Question 4. Do you have any comments on the introduced clarification on the implementation of the quantitative threshold described in Article 4(1)(c)(i) and 4(1)(d)(i)?

We would like to raise the following attention points regarding Article 3.3 of the new RTS where several cases should be assessed as a single change.

Firstly, modifications of the same nature and to the same rating system implemented sequentially over time should be bundled in a single model change. We consider the proposal to aggregate changes to different rating systems or to be implemented sequentially over time as positive. Nonetheless, we deem that greater clarification is needed in the sentence “*sequentially over time*”. Is it limited to stepwise implementation plans of a single change or is it intended also as multiple uncorrelated changes to the same rating systems: e.g. subsequent re-calibration shall be considered as separate changes? Another example could be linked to changes due to Competent Authority findings, which may have six months long action plans: shall we consider the changes as separate, although within 12 months? In this case, we understand that we notify upfront the supervisor with a plan of changes (changes that we identify so far), and if we apply literally the RTS, we may in practice end with a multiyear plan. In this regard, **the RTS could clarify that it leaves the possibility for the bank to introduce a reasonable limited timeframe to the changes to be bundled.**

When being required to treat phased changes as a single change for the purposes of its impacts, some issues may occur when we try to comply with IT readiness requirements. In the logic of the RTS, if readiness to implement is required for the entirety of the change, the change could only be requested once everything has been completed, effectively eliminating any opportunity for phasing. We are of the view that it should be clarified that in cases where changes need to be phased, readiness to implement should only be considered for the portion that can be implemented initially (when the change is notified).

As mentioned by the EBA, one change affecting multiple rating systems is considered as a single change. Consequently, **we understand that it leads to an aggregation the RWA impact of the change across the rating systems affected.** In the case of one change affecting several rating systems do we understand correctly that only the check of 1.5% decrease at overall consolidate level is needed to be done? Indeed, if no control at single rating system shall be done under the new formulation concretely the 15% decrease threshold is not applicable. In this case, the RTS should clarify that banks are expected to only report the aggregated metric (no calculation at the level of one rating system). Moreover, is this approach valid only in case of changes affecting all the IRB Rating systems of an institution or only for part of them? For example, if a change impact only 2 rating systems out of 10 in a local Bank model landscape should the impact of change be assessed versus the 1.5% instead of the 15% for the 2 rating systems?



Finally, precision is expected to specify that such bundle of model changes also apply for changes of model perimeter impacting several rating systems. It is quite common for a revisitation of rating system perimeters to simultaneously involve both extensions and reductions. For instance, changes in segmentation (especially for legal persons) should be assessed as a whole due to the inherent dependencies across different rating systems (e.g., depending on turnover, a customer could fall into Large Corporates, Enterprises, or SMEs). In our view, assessing a change in segmentation separately as reductions and extensions artificially inflates the materiality. Instead, **we believe a more effective way to streamline the supervisory decision process would be to assess segmentation changes as a single and standalone type of change.**

**Question 5. Do you have any comments on the revised 15% threshold described in Article 4(1)(d)(ii) related to the materiality of extensions of the range of application of rating systems?**

The overall logic of the amendments is basically clear. **As per our general comments, we support combining both qualitative and quantitative triggers for a classification as a material change**, together with a supervisory flexibility to avoid an overly mechanical approach. This would be all the more relevant for cases of extensions of the range of application of rating systems, considering the perceived flaws of the new proposed ratio as illustrated below.

As a matter of fact, the new ratio introduced by the EBA may lead to counterintuitive results. To illustrate such issue, let us assume we have an extension on perimeter B of the rating system initially applied to A. We understand from the new EBA requirement that the new ratio will be calculated in the following way:

$$New\ ratio = \frac{RWEA_B^{after}}{RWEA_A^{before}}$$

We can derive two cases in the calculation:

<b>Example 1</b>	EAD	RWEA - Before	RWEA – After	New ratio
Perimeter A	100	50	50	
Perimeter B	100	50	5	10%
Perimeter A+B	<b>200</b>	<b>100</b>	<b>55</b>	

<b>Example 2</b>	EAD	RWEA - Before	RWEA – After	New ratio
Perimeter A	100	50	50	
Perimeter B	100	50	100	200%
Perimeter A+B	<b>200</b>	<b>100</b>	<b>150</b>	

In Example 1, the model extended on perimeter B will lead to an important RWA reduction on the additional exposures (division by 10 of the RWA impact with  $RWEA_B^{after} = 5$ ) and the new calculation results in a 10% ratio. In Example 2, the model extended on perimeter B will double the RWA impact on

the additional exposures (100 after compared to 50 before) and the new calculation will result in a 200% ratio. The new calculation will imply that the scrutiny should be on the Example 2 case. However, the high reduction of RWA is observed for the Example 1 for which the model initially applied on A will lead to reduce significantly the RWA if it is applied on perimeter B.

**Finding alternative solutions to define this ratio could be further explored between the EBA and banks.**

For instance, alternative metrics could be based on other measures such as for instance EAD or other possible metrics. The choice of alternative solutions should however be taken in the light of the results of an impact assessment for banks.

As the reality is more complex, some difficulties may rise along the calculation:

- The new ratio needs to be adapted in the case of both reduction and extension happening at the same time. In this context, we understand that the requirement to have a single change (several changes bundled) will imply that it is possible to have compensation effects if any.
- The IRBA approach could be extended to approaches in STD or FIRB, thus the new ratio will not necessarily capture this aspect as it will be calculated on perimeters with RWA treated in IRBA approach.
- Shall the RWA impact, under the new formulation, be quantified at the level of rating system or at the level of scope of application of a model (PD-LGD-CCF)? Indeed, the extension could occur also at a level of a single parameter and not necessarily contextually on all parameters at the level of rating system. As such the perimeter of application of the different single parameters may be different (thus changing the denominator of the new RWA change metric foreseen in the draft RTS).

Given all these hurdles to define a ratio which will be suitable for all situations, as an additional measure, more room for flexibility should be introduced in the sentence: *“This risk of this weak model performance on the new exposures becomes more pressing the larger the extensions of range of application of the rating system is in comparison to the existing range of application”*. It is indeed possible that the RWA increases by more than 15%, but the actual performance measured in terms of ranking ability is under a significant threshold; in this case, **we deem that a classification as material may be excessive and that further justification on performance could be added to support the non-materiality despite the RWA increase.**

**Question 6. Do you have any comments on the documentation requirement for extensions that require prior notification?**

**Validation report as per requirement of Article 8(1) of the RTS:**

Consultation Box 6 states: *“It was considered that validation processes of institutions may be hampered if they are required to provide, for extensions that require prior notification, also the technical documentation and the assessment report of the validation function. In particular, this implies that an institution either has to wait for the periodical validation process before submitting the extension notification, or perform an ad-hoc assessment by the validation function in order to submit the extension*

*for prior notification.*” We confirm that the validation process would be hampered by the proposed request on non-material extensions:

- The periodical validation process is executed according to the rules defined on the ECB Supplementary Validation Reporting, which ask that the annual validation process assesses a model version in production (not proposed, under assessment by the JST) and, in the case of PD, ask to perform the tests on the model version in production at the beginning of the observation period (e.g. for the 2025 ongoing validation with observation period 31-12-23 to 31-12-24, the model version in production at 31-12-23 shall be considered). This means that the former proposal “wait for the periodical validation process before submitting the extension notification” is not applicable.
- An ad hoc assessment may be the only option. Nonetheless, we would like to point out that, starting from 2024, a validation assessment is also to be included for a non-material change, when it is aimed at addressing Regulatory Findings (“a Supervised Entity may not consider that a remediation action has been fulfilled for a Regulatory Finding unless the Internal Validation Function or Internal Audit Function has confirmed that fulfilment”). For the same reasoning above on the impossibility to leverage on the periodical validation process, this request is a further additional ad-hoc activity that will hamper the validation process.
- This creates in our view a burdensome obligation that is beyond the expectations of the EBA handbook that in paragraph 96.c clearly states that “for non-material changes to a rating system the review of the changes could be performed during the regular (yearly) validation activities, and the result of the validation function’s assessment would be communicated to the CA via the usual validation report”. This paragraph 96.c provides room for synergies, avoiding duplication of efforts (like writing of two reports or launching of the same test on to different reference dates) and giving more flexibility on the executions of annual plans. We find this requirement disproportionate and are concerned about the impact it entails in terms of effort and its alignment with Internal Validation’s annual plans, which are already under significant strain.

For these reasons, it is worth identifying a set of tests to meet the EBA expectation on the topic, e.g. the validation deliverable in case of non-material extensions could cope with representativeness, rank ordering, stability (in case leveraging on and verifying what executed by Modelling for classification purposes). Therefore, **regarding documentation listed in Article 8(1) of this RTS, the assessment report is understood as a minima a review of the model change classification (representativeness) and not a full review report of the model of the independent review team.** Such clarification in the RTS will be welcome.



**Model performance definition:**

Moreover, we also understand from the EBA public hearing that in this context “**model performance**” is **not understood as an anticipated backtesting exercise**, therefore it is not required from institutions to submit results of a first backtesting exercise when filing for extensions (first backtesting exercise is made after implementation of the models). We think that such stance will be better understood by supervisors if it is clearly mentioned in the RTS.

Yours sincerely,

**The EURO CRO Group**

José Luis Elechiguerra  
BBVA

Frank Roncey  
BNP Paribas

Franck Leroy  
Groupe BPCE

Bernhard Spalt  
Commerzbank

Alexandra Boleslawski  
Crédit Agricole

Olivier Vigneron  
Deutsche Bank

Ljiljana Čortan  
ING

Davide Alfonsi  
Intesa Sanpaolo

Mark Kandborg  
Nordea

Mahesh Aditya  
Grupo Santander

Stéphane Landon  
Société Générale

TJ Lim  
UniCredit Group