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TO : EBA - CONSULTATION

EBA CONSULTATION ON RTS MODEL CHANGE

FBF RESPONSE TO EBA CONSULTATION PAPER ON DRAFT REGULATORY TECHNICAL STANDARDS (RTS) FOR ASSESSING THE MATERIALITY OF EXTENSIONS AND CHANGES OF THE INTERNAL RATINGS BASED APPROACH.

INTRODUCTION

The French Banking Federation (FBF) welcomes the opportunity to provide feedback on the EBA's draft Regulatory Technical on model change.

We appreciate the European Banking Authority's (EBA) efforts to provide greater clarity and adaptation on the draft Regulatory Technical Standards (RTS) and to target an harmonized approach and clear evaluation criteria.

For years, Commission Delegated Regulation 529/2014 has provided the common rules for banks to classify their IRB model changes.

With the TRIM review, banks have undertaken substantial investments in large projects and made significant structural revamping of their IRB models in line with the "IRB Repair" requirements set by the EBA.

In the context of CRR3, proposed amendments to the regulation by the current EBA consultation have raised concerns among French banks, as the consequences of material model changes may impact the entire credit rating process and the broader risk framework.

As part of the ongoing improvement of the IRB framework, it is crucial for banks to maintain transparency and continuous communication with their supervisors regarding planned model changes.

The level of involvement of banks and supervisory authorities depends on the classification of the model change. A material modification often results in an Internal Model Investigation (IMI) mission with a substantial investment and a process that can last several years until supervisory approval is granted. The duration of this process may deter the rapid implementation of changes that improve the IRB framework. Although the EBA consultation paper includes simplifications, we note that the new features introduced do not significantly reduce the burden on banks and supervisory authorities, as many changes would still be classified as material. Therefore, we support initiatives to further simplify the framework.

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. To foster an efficient framework for all parties, **the level of materiality of model changes should become commensurate to the level of prioritization of invested resources.** Such **proportionality** in

the approach would ensure that resources are allocated to important areas, while accelerating the implementation and alleviating the burden for changes considered of less priority.

With the experience developed so far including the implementation of CRR3, the level of enhancement of the internal models can be considered as high as well as the experience gained through the supervision of such models. In this sense, the **level of maturity of the European IRB framework in the banking industry can be considered as advanced**, where only minor changes are planned to be considered. We would also like to emphasize the **need for stability and predictability in the rules** applicable to IRB models considering the negative impact of continuous changes in the regulatory requirements and the complementing supervisory expectations since IRB Repair (included).

In this context, the FBF (French Banking Federation) welcomes the opportunity to respond to the EBA consultation on the RTS for assessing the materiality of extensions and changes to the IRB approach.

We welcome some simplifications introduced by EBA proposal. However, relying on our experts, EBA newly introduced features would not significantly reduce the burden for both banks and supervisors, as numerous model changes would still be classified as material. That's why the FBF emphasizes the necessity of **prioritizing quantitative triggers over qualitative triggers** and **supports the introduction of an "expert judgment" factor**. This factor would allow supervisors and banks **to reclassify a novelty from "material" to "non-material."**

The main areas of concern for the FBF regarding the new RTS are as follows:

- From a broader perspective, we believe the rule for qualifying a model change should be **simplified by allowing supervisory discretion** to prevent an overly mechanical decision to classify changes as material. A **judgmental layer left to banks and supervisors** should enable reclassification from material to non-material change. Additionally, more frequent classification to ex-ante notification instead of material change could be achieved by **combining quantitative and qualitative criteria differently**, as explained in our response.
- The EBA 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.
We wish to emphasise our general preference for this approach, which in our view may be further enhanced by incorporating the general idea of **flexibility** granted to competent authorities for the requalification of the model changes, as follows :
 - 1) *If **both qualitative and quantitative criteria** for material change are met, the change should be considered material, unless the competent authority makes use of the above-mentioned judgmental reclassification.*
 - 2) *If **only one of the two criteria** is met:*
 - a) *If only the **quantitative criteria** is met, the change should be **considered material**, subject to the competent authority validation (or else it is requalified as an ex-ante notification)*

*If only the **qualitative 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.*

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

- In order to **further simplify** the framework, **some specific model changes that would be classified as non-material** requiring an ex-ante notification according to the CDR 529/2014 article 5(1.a) **could be internally managed and approved based on an internal independent review**. Such framework where the approval of the ex-ante notification is therefore left to the bank could be further reflected and defined between the EBA and banks (such as identifying minimum standards for the independent review). We could contemplate that the scope would concern **changes to rating systems triggered by the remediation of an ECB obligation or changes to rating systems with limited RWA impact** (any increase or a decrease lower than 5% at the level of the rating system). For these cases, we suggest to reflect on potential acceleration of their implementation by for instance communicating to the JST the internal validation of the change, ahead of its implementation, within a **timeframe** shorter than two months (e.g. 2 weeks).
- A refinement of the scope is needed : Frequent recalibration should be facilitated by notifying the supervisor **after implementation**. Similarly, clarity in the Recital is expected regarding the **extension of existing IRBA rating systems** to additional exposures **initially treated under the STD/IRB-F approach** to avoid systematic categorization as material changes in the implementation of banks' rollout plan.
- For the classification of changes to the **definition of default** (DOD), 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 the EBA regarding this RTS, we propose **excluding changes to the assignment of exposure classes** from the scope of the RTS.
- We encourage simplified model changes when introducing **ESG risk drivers**, which could be achieved by introducing an arrangement allowing **mandatory classification as ex-ante notifications for a transitional period**.
- Issues regarding the new assumptions introduced in the framework, such as the new ratio introduced for model extensions, need to be addressed.

Detailed answers to the questions highlighted by the EBA can be found below.

FBF RESPONSES TO EBA'S QUESTIONS:

Question 1: Clarification of the Scope of the Draft Revised Regulatory Technical Standards

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?

The FBF appreciates the effort to clarify the scope of the draft revised RTS. The data elaboration improves the interpretation of the Level 1 text.

However, we note that :

- Mechanical recalibration following backtesting or mechanical updates to risk factors due to the addition of an extra year of default should be notified after implementation to reduce the burden. If this is not the case, in particular when machine learning techniques are used, the numerous changes which are structurally part of the models would generate prior notifications / approvals thus congesting the process.

The FBF proposes precisising recital (2) to reflect these distinctions:

EBA proposal	New proposal
"Modifications to rating systems as defined in Regulation (EU) No 575/2013 may have a potential impact on internal risk estimates used for the calculation of the risk-weighted exposure amount and, as such, include changes affecting the scope of a rating system, the rating methodology for IRB systems, the definition of default and the validation framework, as well as changes to relevant processes, data and model usage. Updates to data used in the development and calibration of rating systems requiring human intervention should therefore be covered by this Regulation."	"Modifications to rating systems as defined in Regulation (EU) No 575/2013 may have a potential impact on internal risk estimates used for the calculation of the risk-weighted exposure amount and, as such, include changes affecting the scope of a rating system, the rating methodology for IRB systems, the definition of default and the validation framework, as well as changes to relevant processes, data and model usage. Updates to data used in the development and calibration of rating systems requiring human intervention should therefore 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>

- 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.
- Regarding the **inclusion of relevant ESG risk factors** in IRB models, only when future regulation regarding these aspects will be settled, the FBF suggests a **transitional arrangement** to incorporate ESG-risk drivers (if considered relevant and material) in order to avoid delays. This could involve a **period where banks submit ex-ante notifications** to include ESG risk factors without needing to perform a complete analysis of the ranking or distributions of obligors.
- As envisaged in the EBA statement on CRR3 implementation, changes **mandated by regulation** (such as reversion to a less sophisticated approach) that do not affect model performance should be permanently outside the scope.

Question 2: Qualitative Criteria for Significant Changes

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)

- The FBF welcomes the EBA's initiative to improve the distinction between changes that result in a significant change and those that require **ex-ante notifications for the Definition of Default (DoD)**.
- The EBA requirements are understood as leading to encompass in material categorization an extensive range of **changes to definition of default** which are related mostly to operational implementation issues. Not only these changes may 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 is an improvement of the framework, does not modify the result of the identification of default and do not impact the rating systems. This is why in the first place, we would introduce a **distinction between changes with an impact on ratings systems and changes with no impact on rating systems**. In addition, the list of cases underlined in the RTS would not be exhaustive enough to cover all possible cases and will be subject to various interpretation, except for the change of level of application of definition of default (which will probably imply a rebuilding of the model). In this perspective, the most objective way to assess the impact would be **to rely more on quantitative metrics** (e.g.: impacted default volumetry).
- The FBF proposes to amend the RTS (Annex I, Part I, Section 1) to **clarify changes to the definition of default** in accordance with Article 178 of Regulation (EU) No 575/2013:

EBA proposal	New proposal
<p>3. Changes in the definition of default according to Article 178 of Regulation (EU) No 575/2013, if any of the following conditions are met:</p> <p>(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;</p> <p>(b) 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;</p> <p>(c) they change the use of external data according to Article 178(4) of Regulation (EU) No 575/2013;</p> <p>(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;</p> <p>(e) 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.</p>	<p>3. Changes in <u>the methodologies and rules</u> to the definition of default according to Article 178 of Regulation (EU) No 575/2013, if any of the following conditions are met:</p> <p>(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;</p> <p>(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;</p> <p>(c) they change the use of external data according to Article 178(4) of Regulation (EU) No 575/2013;</p> <p>(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;</p> <p>(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></p>

Such change is also accompanied by the **deletion of the quantitative criteria**, as impact on risk parameters will be captured by other criteria of the RTS when assessing the materiality of changes on models following a change in the definition of default. In other words, the change is assessed in **two-step approach**: first on the change in definition of default, second on the impact on models.

- Changes in the methodology used to **assign exposures to different exposure classes** (in accordance with Article 147 of the CRR) are reclassified as ex-ante notifications in the new RTS. The FBF believes that these changes **should be excluded from the scope of the RTS** when they do not affect the models. Indeed, the 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”. 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
- As mentioned in the criteria 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 change and non-material change is objectively captured through RWA impact, rather than through more subjective criteria determined by the bank. This is why **the limits between material and non-material regarding methodologies for estimating PD/LGD should be based on other quantitative criteria** (RWA outcomes), which metrics are defined by the bank. Such possibility should be written in regulation.

Question 3: Qualitative Criteria for Extensions and Reductions

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?

- The FBF believes that the clarifications and revisions of the qualitative criteria for assessing the relative significance of extensions and reductions constitute an improvement.
However, as mentioned above, **changes to exposure classes** that do not affect the models should be **excluded** from the scope of the RTS.

In accordance with paragraph 19 of the explanatory memorandum, the EBA mentions that *"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 IRB-F if the scope of an LGD model is extended) require in all cases approval by the competent authority and are not within the scope of this RTS"*.

But Article 148(1) only concerns the approval of the roll-out plans and does not concern the application for **approval of a new rating system**.

- ✓ Recital (3) could be misunderstood as now excluding IRB extensions to STD/IRB-F exposures from the RTS, which were understood as being in the scope of CDR 529/2014.
- ✓ We propose: roll-out plans (Article 148(1)) may include extending IRBA systems to STD/IRB-F approaches. When implementing the roll-out plan, such extensions should remain within the scope of delegated regulation 529-2014, allowing assessment of representativeness as well as quantitative criteria to decide for potential ex-ante notification.
- ✓ Automatic material change classification for such extensions would hinder roll-out plan implementation as supervisory expectation from ECB Guide to Internal Models recommends an implementation within a timeframe of 5 years.

Therefore, the **RTS should clarify** that **extending existing IRBA systems to STD/IRB-F** can qualify for **ex-ante notification**, contingent on materiality assessment and representativeness analysis, balancing rigor with efficient IRB roll-out.

Question 4: Quantitative Threshold

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)?

- The FBF welcomes the clarification on the implementation of the quantitative threshold. If the interpretation is correct, several different changes should not be assessed individually, such as modifications of a different nature made simultaneously to the same rating system or modifications of the same nature and to the same rating system implemented sequentially over time
- The FBF would like the EBA to **clarify the aggregation of RWA impacts for changes affecting multiple rating systems**.
With regard to Article 3.3, several cases should be assessed as a single change. The FBF would like to draw attention to certain points: modifications of the same nature and of the same rating system implemented sequentially in time should **be grouped together as a single model change**. In this case, the FBF understands that it notifies the supervisory authority in advance of a plan of changes (changes that we identify so far) and that it can, in practice, result in a **multi-year plan**. In this regard, the RTS could specify that it leaves the possibility of **introducing a reasonable and limited period** for the grouping of changes.

Question 5: Revised Threshold of 15%

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?

- As seen before, we support the EBA's proposed amendments to assess model changes and extensions by combining qualitative and quantitative triggers, with supervisory flexibility to avoid overly mechanical approaches. This is particularly relevant for rating system extensions, given potential issues with the new proposed ratio.

However, **the new ratio introduced by the EBA may lead to counter-intuitive results**, particularly in the event of simultaneous reductions and extensions. The FBF believes that it is not operational on sub-perimeters or in the event of simultaneous reductions and extensions.

Two scenarios illustrate the issue:

Definition of the new ratio = (RWEA of B after extension) / (RWEA of A before extension)

RWA Reduction Case 1: If Perimeter A (before): RWEA = 50 and Perimeter B (after): RWEA = 5, then New ratio = 10%

RWA Increase Case 2: If Perimeter A (before): RWEA = 50 and Perimeter B (after): RWEA = 100, then New ratio = 200%

Paradoxically, the ratio suggests more scrutiny for the second case, while the first case represents a more significant change (90% RWA reduction).

Given these challenges, we believe that more flexibility is recommended in assessing materiality, particularly when RWA increases significantly but **actual performance** (e.g., ranking ability) **remains strong**.

While waiting for further discussions between French banks and the EBA to define alternatives and to assess their impacts, our preferred option is to **maintain the current assumptions and wording of the ratio (status quo)**.

Question 6: Documentation Requirement

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

- The **assessment report**, as listed in Article 8(1) of these RTS, is understood to be a **review of the classification of model changes** (representativeness) and not a complete model review report by the independent review team. Indeed, the validation report requirement stipulated in Article 8(1) of the RTS presents significant challenges for credit institutions, particularly concerning non-material model extensions. In fact, this approach appears to contradict the EBA handbook where paragraph 96.c explicitly indicates 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". It is therefore preferable to rely on the framework laid down for the internal independent review.

- The FBF understands that "**model performance**" is not an anticipatory backtesting exercise and that institutions are not required to submit the results of an **initial backtesting exercise** when submitting applications for extensions (the first backtesting exercise is carried out after the implementation of the models). The FBF believes that this position will be better understood if it is clearly mentioned in the RTS.

We trust that these comments will be helpful to the EBA in finalizing its RTS. We remain available to discuss these issues further and to provide any additional information that may be required.

The EBA consults on draft technical standards that specify material changes and extensions to the Internal Ratings Based approach / European Banking Authority

<https://www.eba.europa.eu/sites/default/files/2024-12/4cead1ed-a210-435c-9134-e04066fe9bc6/Consultation%20Paper%20on%20draft%20%20RTS%20on%20material%20model%20change.pdf>

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