

Technical note on
**Draft RTS on the assessment of
material changes and extensions of
IRB models**

Executive summary of EBA's consultation paper

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1 Executive summary

General overview

These RTS seek to improve supervisory efficiency, update regulations in line with the CRR, and simplify the approval process for internal model modifications under the IRB approach

Context

- Regulation 2024/1623 (CRR3) introduced significant modifications to the regulatory framework established by Regulation 575/2013 (CRR), impacting key aspects related to **credit risk management** through the **IRB approach**.
- Under CRR, Article 143(5), **EBA shall develop 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.

Objective

- Enhancing the supervisory effectiveness of the **approval process** for **model changes and extensions**, leveraging 10 years of supervisory experience gathered since the publication of the original RTS.
- Ensuring **consistency** and **clarity in the evaluation of modifications**.
- Contributing to the stability and integrity of the financial system.

Next steps

- **January 15, 2025.** Public hearing.
- **March 10, 2025.** Consultation period ending,

General overview



1. Scope of the RTS

2. Qualitative criteria for assessing the materiality of changes



3. Qualitative criteria for assessing the materiality of extensions and reductions

4. Quantitative criteria for material changes and extensions



5. Alignment with CRR III

6. Documentation and IT requirements



2 Detailed overview

Scope of the RTS



EBA clarifies that changes outside the rating systems are not within the scope of this RTS

Inclusions within the scope of the RTS	
Rating systems	<ul style="list-style-type: none"> • Changes to rating systems, as defined in CRR, may impact internal risk estimates used for risk-weighted exposure amount calculation. These include changes to the range of application of a rating system, rating methodology for IRB systems, definition of default, and validation framework, as well as updates to relevant processes, data, and the use of models. • Updates for ongoing application data and new originations of existing exposure types are included.
Development and calibration processes	<ul style="list-style-type: none"> • Changes to development and calibration processes (including the respective reference datasets) to align with the approved methods, processes, controls, data collection, and IT systems.
Ongoing application portfolio	<ul style="list-style-type: none"> • Updates to the data application portfolio used in the ongoing application of the rating systems to calculate the RWEA for the application portfolio, based on the approved methods, processes, controls, data collection, and IT systems.
Exclusions from the scope of the RTS	
Non-rating system parameters	<ul style="list-style-type: none"> • Changes in non-rating system parameters (e.g., Maturity, Total Annual Sales, SA-CCF assignments) impacting RWEA formulas but not rating system performance are excluded.
Development and calibration processes	<ul style="list-style-type: none"> • Changes to development and calibration processes remain within scope only when affecting internal risk estimates, such as rating methodologies and validation frameworks.
Regulatory values	<ul style="list-style-type: none"> • Implementation of regulatory values (e.g., new PD, LGD, CCF input floors, updated credit risk mitigation parameters) and updates to risk weight functions (e.g., deletion of the 1.06 factor) are excluded from the RTS and require neither notification nor authorization.
Institutions' responsibilities under the RTS	
<ul style="list-style-type: none"> • Assess, categorize, and bundle changes impacting rating systems for approval or notification. • Prioritize implementation and remediation plans, which should be discussed with competent authorities. • Mandatory changes not affecting performance require neither authorization nor notification. 	



The RTS proposal reclassifies certain aspects previously considered as material changes into non-material changes that only require notification

Clarifications on qualitative aspects to consider when assessing changes to rating criteria

- When institutions **modify their rating criteria**, the RTS require them to establish an appropriate **framework** to **evaluate how significant the changes** are. Specifically, this includes **assessing**:
 - (i) Changes to rank ordering
 - (ii) Changes to the distribution of obligors, facilities, or exposures across risk categories or groups (grades or pools).
- Institutions must **define adequate metrics** or **measures** and an appropriate level for both cases. The EBA clarifies that these **metrics should be based on final ratings or risk parameters** (from both the approved and changed models).
- For grouped exposures in pools/ grades, rank ordering should **rely on final estimates** associated with grades/ pools, not intermediate scores.
- In the case of **supervisory slotting criteria approach (SSCA)**, rank ordering should be derived from the **allocation to risk weight buckets**.

Qualitative changes recategorized from material to ex-ante notification

- **Definition of Default (DoD):**
 - (i) A revision is made to **limit material changes** related to the definition to **aspects where the implementation of the changes may be more complex** and may imply a higher risk of non-compliance pertaining to the identification of defaulted exposures as referred to in Article 178 of Regulation (EU) No 575/2013.
 - (ii) A change of the definition alone does not change the risk weighting of non-defaulted exposures. **DoD changes impacting the model performance** to the extent that a new model would need to be developed, or a new calibration is necessary, would be **captured via other criteria in the RTS**.
 - (iii) **Complex changes identified:** 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, changes to the level of application of the DoD for retail exposures according to CRR Article 178(1), changes to the use of external data according to Article 178(4), and changes whether an indication of Unlikelihood to Pay results in an automatic or in a manual default reclassification. **As backstop measure** is added to identify other cases, a change related to DoD is deemed material when it impacts the default classification of the exposures in the range of application of a rating system in a significant manner
- **Validation methodology:** Only changes leading to more lenient assessments are classified as materials according to Article 185(a) of Regulation (EU) No 575/2013. Stricter or equally conservative changes require **ex-ante notification**.

Qualitative changes removed from ex-ante notification

- Changes to **Supervisory Slotting Criteria Approach (SSCA)** and **purchased receivables treatment** reclassified:
 - Now treated the same as other rating systems.
 - Subject to general materiality criteria, with prior notification required only if quantitative thresholds are exceeded.
 - Clarified that ranking and distribution changes should be considered in relation to risk weight buckets under the updated RTS.

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Detailed overview

Qualitative criteria for assessing the materiality of extensions and reductions



The RTS proposal clarifies the distinction between extensions under Article 148(1) and the RTS scope, simplifies model extension categories, and reclassifies changes in exposure assignment methodology as prior notifications

Cases Outside the Scope of the RTS

- **Extensions under Article 148(1).** Exposures not previously risk-weighted (e.g., under the Standardized Approach or F- app) require approval by competent authorities. These changes are covered under Article 148(1) and are **excluded from the RTS scope**.
- **New origination of exposures already rated.** Exposures of a type already rated under the IRB approach and **not considered extensions** of a rating system. Therefore, these are **excluded from this RTS**, as they do not constitute a material extension.

Simplified Categorization of Extensions

- **Approval** required for **extensions to additional exposures, unless the institution demonstrates the rating system's representativeness** for the new exposures.

Concept of Representativeness Linked to CRR3

- **Commission Delegated Regulation (EU) 2022/439.** Concept of representativeness must be demonstrated to apply the derogation of required approval for extensions. This is covered in **Article 37(2)** pertaining to the **risk differentiation capacity** of the rating system, and to **Article 42(2)** pertaining to the **risk quantification capacity** of the rating system.

Classifications update

- **Ex-ante notification now required** for:
 - Changes in the methodology for assigning exposures to **different exposure classes**.
 - Changes in the methodology for assigning obligors/transactions to a **rating system**.
 - These changes may affect RWEA, but their impact results from applying new prescribed inputs (e.g., RWEA formulas, input floors) rather than changes to the rating systems themselves.
- **Material** model changes that **remain within scope** include:
 - Extensions of the range of application of a rating system where **representativeness is not demonstrated**.
 - Changes breaching **quantitative thresholds** outlined in RTS **Articles 4(1)(c) and 4(1)(d)**.

Quantitative metrics for material changes and extensions



The consultation paper proposes revised quantitative thresholds for IRB rating systems, clarifies criteria for treating grouped modifications as single changes, and updates thresholds for extensions and reductions to ensure consistent risk assessment

Quantitative metrics for material changes to rating systems

- **Clarifications on thresholds:**
 - **Thresholds revised** to clarify their scope for changes and extensions/reductions in rating systems.
 - Similar changes (e.g., phased updates to collateral recovery methodology) must be treated as one single change, regardless of timing.
 - For example, phased changes applied to different collateral types constitute a single change and require one materiality assessment.
- **Single Change Impacting Multiple Rating Systems:**
 - Changes impacting **multiple rating systems** are assessed as one single change by aggregating RWEA impact across all systems.
 - Prevents dilution of the threshold impact by **splitting the assessment across systems**.
 - Example: A Definition of Default (DoD) change affecting multiple systems is evaluated as a single change under Article 4(1)(c)(i).
- **Alternative consideration:**
 - Institutions could assess thresholds individually for each rating system, potentially reducing complexity, but this approach risks inconsistent outcomes and was not adopted.

Quantitative metrics for extensions and reductions

- **Reductions:**
 - No quantitative threshold; ex-ante notification is sufficient.
 - Risks from reductions are captured in other frameworks, such as Article 149 for reversals to less sophisticated approaches or extensions to other rating systems.
- **Extensions:**
 - The 15% threshold in Article 4(1)(c)(ii) does not fully address risks of poor model performance for new exposures.
 - A new threshold in Article 4(1)(d)(ii) calculates the ratio of RWEA for additional exposures to RWEA of the existing range.
 - This ensures risks from significant extensions are appropriately captured.
- **Alternative Approach Considered:**
 - Previously, thresholds were calculated as the RWEA difference pre- and post-extension. This simpler approach was considered but replaced with the new ratio-based threshold.

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Detailed overview

Alignment with CRR III, documentation and IT requirements



The proposal aligns with CRR III by removing outdated regulatory approaches, establishing documentation and IT requirements to ensure transparency, and detailing obligations for technical validations and IT implementation of rating systems.

Alignment with CRR	Unfunded Credit Protection (UFCP)	<ul style="list-style-type: none"> Regulation (EU) 2024/1623 aligns with Article 183, broadening paragraph 2(i) to include UFCP changes affecting institutions' LGD estimates. Ex-ante notification is required for shifts between PD/LGD modelling and substitution approaches under A-IRB (Article 236a).
	Standardised Approach	<ul style="list-style-type: none"> Article 150(1)(a) mandates its use for equity exposure class, removing references to internal models for equity and AMA for operational risk.
Documentation and IT requirements	IT Systems	<ul style="list-style-type: none"> Institutions must implement IT systems for IRB risk parameter estimates, RWEA calculation, and COREP reporting, as clarified under Article 144(1)(g) of Regulation (EU) No 575/2013.
	Documentation for Extensions	<ul style="list-style-type: none"> Institutions must submit complete documentation, including validation assessments and technical reports, for extensions regardless of approval or notification. This ensures effective regulatory oversight.
	Validation Challenges	<ul style="list-style-type: none"> Consultation highlights potential delays in validation processes due to required documentation for prior notification extensions.

6 | Why Management Solutions?

MS has extensive experience in risk and capital management, particularly in the processes of compliance with the associated regulation (CRR/CRD)

MS differential values in risk and capital management

- 1. Experience with supervisory bodies.** MS is a "highly rated external service provider" in internal capital models by different European and American Supervisors. In particular, it has 7 framework service agreements with the ECB related to internal models and is the highest rated provider in the capital area.
- 2. Regulatory modelling.** MS has extensive experience in modelling: (i) credit risk (IRB, IFRS 9 & CECL, stress testing, others), (ii) market risk, CCR and IRRBB (VaR, pensions, xVA); (iii) ALM and liquidity; (iv) residual value; and (v) economic capital, among others.
- 3. Independent validation.** MS collaborates with different institutions as an independent supervisor of internal models, verifying compliance with regulatory requirements (e.g. CRR, EBA, ECB Guidance on internal models...) to obtain approval from regulators (e.g. ECB, DNB, Bundesbank...).
- 4. Experience in the design and implementation of capital calculation engines.** MS has extensive experience in supporting institutions in the design and implementation of capital calculation and reporting solutions (including our proprietary MIR and SIRO tools), as well as in the execution of capital impact analysis exercises, optimisation...
- 5. Specialised team.** MS has a team of experts in the field of risk and capital management (modelling, regulation, impacts, information systems, reporting...), combining quantitative and technical expertise with strong regulatory knowledge.
- 6. Assessment Capabilities in IRB Models.** MS has extensive experience in the redesign and validation of IRB models, including IFRS9 model redevelopment and support for Model Owners. MS teams have successfully prepared IRB application packages for specific portfolios, participated in TRIM missions and S-REP in-depth reviews, and executed remediation plans to address ECB obligations. Additionally, MS has supported the positioning and role definition of risk control areas within banks, documenting internal policies and standard procedures, and addressing supervisory findings effectively.

Abbreviations


A-IRB	Advanced Internal Ratings-Based
ALM	Asset and Liability Management
CCF	Credit Conversion Factor
CRR	Capital Requirements Regulation
CCR	Counterparty credit risk
CDR	Commission Delegated Regulation
COREP	Common Reporting
CRCU	Credit Risk Control Units
CCR	Counterparty credit risk
DoD	Definition of Default
EBA	European Banking Authority


IFRS1-9	International Financial Reporting Standards 1 to 9
IRB	Internal Ratings-Based
LGD	Loss Given Default
MB	MainBrand
NMB	Non-MainBrand
PD	Probability of Default
RTS	Regulatory Technical Standards
RWEA	Risk-Weighted Exposure Amount
SA-CCF	Standardized Approach - Credit Conversion Factor
SREP	Supervisory Review and Evaluation Process
SSCA	Supervisory Slotting Criteria Approach
TRIM	Targeted Review of Internal Models




International
One Firm


Multiscope
Team


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know-how


Proven
Experience


Maximum
Commitment

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