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Consultation Paper

Draft regulatory technical standards
on the sequential implementation of the IRB Approach and
permanent partial use under the Standardised Approach under
Articles 148(6), 150(3) and 152(5) of Regulation (EU) No 575/2013
(Capital Requirements Regulation– CRR)

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1. Responding to this consultation

The EBA invites comments on all proposals put forward in this paper and, in particular, on the specific questions summarised in Section 5.2.

Comments are most helpful if they:

- respond to the question stated;
- indicate the specific point to which a comment relates;
- contain a clear rationale;
- provide evidence to support the views expressed/rationale proposed; and
- describe any alternative regulatory choices the EBA should consider.

Submission of responses

To submit your comments, click on the 'send your comments' button on the consultation page by **26.09.2014**. Please note that comments submitted after this deadline, or submitted via other means may not be processed.

Publication of responses

Please clearly indicate in the consultation form if you wish your comments to be disclosed or to be treated as confidential. A confidential response may be requested from us in accordance with the EBA's rules on public access to documents. We may consult you if we receive such a request. Any decision we make not to disclose the response is eligible for review by the EBA's Board of Appeal and the European Ombudsman.

Data protection

The protection of individuals with regard to the processing of personal data by the EBA is based on Regulation (EC) No 45/2001 of the European Parliament and of the Council of 18 December 2000 as implemented by the EBA in its implementing rules adopted by its Management Board. Further information on data protection can be found under the legal notice section of the EBA website.

2. Executive summary

The Capital Requirements Regulation (CRR) and the Capital Requirements Directive (CRD) specify prudential requirements for banks and other financial institutions, which have been in use since 1 January 2014. The CRR contains specific mandates for the EBA to develop draft regulatory technical standards (RTS) to specify the conditions of application of permanent and temporary uses of the Standardised Approach (SA) by institutions that have received permission to use the IRB Approach (IRB institutions).

Main features of the draft RTS

Article 148(1) of the CRR provides that institutions and any parent undertaking and its subsidiaries shall implement the IRB Approach for all exposures unless they have received the permission of the competent authorities to permanently use the Standardised Approach in accordance with Article 150 of that Regulation. Subject to the prior permission of the competent authorities, the IRB Approach may be carried out sequentially in a number of ways.

Competent authorities are required to determine the time period for implementing the IRB Approach for all exposures, and the conditions against which institutions shall implement the IRB Approach. These conditions should be designed to ensure that sequential implementation is not selectively used to reduce own-funds requirements regarding the exposures yet to be included in the IRB Approach, or in the use of own estimates of LGDs or conversion factors. Although determining the overall time period is solely a matter for the competent authorities, the EBA is required by Article 148(3) of the CRR to develop draft RTS to specify the conditions that competent authorities should use to determine the appropriate nature and timing of the sequential roll-out.

Permission to apply the SA permanently under Article 150(1) of the CRR can only be granted for certain exposures. The EBA is required by Article 150(3) of the CRR to specify the conditions of application of the permanent use provisions for certain sets of exposure, in particular:

- exposures to central governments and central banks, where the number of material counterparties is limited and it would be unduly burdensome for the institution to implement a rating system for these counterparties;
- exposures to institutions, where the number of material counterparties is limited and it would be unduly burdensome for the institution to implement a rating system for these counterparties;
- exposures in non-significant business units, as well as exposures classes or types of exposures that are immaterial in terms of size and perceived risk profile.

In addition, the EBA is required by Article 152(5) of the CRR to specify the conditions by which competent authorities may permit institutions to use the SA for underlying exposures of the collective investment undertakings (CIUs) that do not belong to the equity exposure class.

The main proposals within these RTS are as follows.

- Definition of the maximum levels of exposure permanently allowed under the SA in the ‘central governments and central banks’ and ‘institutions’ exposure classes, and for immateriality or non-significance reasons. The set of relevant exposures against which the permanently exempt exposures will be measured was defined for this purpose.
- Definition of qualitative criteria against which the competent authorities shall assess whether it would be unduly burdensome to implement a rating system for the ‘central governments and central banks’ exposure class and for the ‘institutions’ exposure class.
- Definition of a minimum initial level of exposures (and risk-weighted exposures) to be treated under the IRB Approach by IRB institutions.
- Definition of qualitative criteria against which the competent authorities shall assess applications of institutions for a sequential roll-out of the IRB Approach.

Next steps

After the consultation ends on 26 September 2014, the EBA will assess the responses received and consider whether or not any changes should be made to the draft RTS.

The EBA must submit the draft RTS to the Commission by 31 December 2014.

3. Background and rationale

The CRR and the CRD specify prudential requirements for banks and other financial institutions which have been in use since 1 January 2014. The CRR contains specific mandates for the EBA to develop draft RTS to specify the conditions of application of permanent and temporary uses of the SA by institutions that have received permission to use the IRB approach (IRB institutions).

Background to these draft RTS

These draft RTS detail a number of provisions in the CRR on the circumstances in which IRB institutions may combine the use of the IRB and Standardised Approaches for credit risk. In summary, the provisions that are relevant to these RTS are as follows.

- Article 148 of the CRR states that the IRB Approach must be used for all exposures unless permission permanently to use the SA has been granted by the competent authorities under Article 150 of the CRR.

Implementation of the IRB Approach may be carried out sequentially across different exposure classes, within the same business unit, across different business units in the same group, or for the use of own estimates of LGDs or conversion factors (for exposures to corporates, institutions and central governments and central banks) where prior permission has been granted by the competent authorities.

Permission to implement sequentially is subject to the setting of a time period over which sequential implementation shall be carried out, and other conditions to ensure that sequential implementation is not used to reduce capital requirements. The EBA is required to develop draft RTS to determine these other conditions.

- Article 150 of the CRR defines a number of categories of exposures for which competent authorities may grant permission for partial use of the SA. A number of these sets of exposures are subject to the conditions of application in regulatory technical standards. The exposures involved are as follows:
 - exposures to central governments and central banks, where the number of material counterparties is limited, and it would be unduly burdensome for the institution to implement a rating system for these counterparties;
 - exposures to institutions, where the number of material counterparties is limited, and it would be unduly burdensome for the institution to implement a rating system for these counterparties;
 - exposures in non-significant business units, as well as exposure classes or types of exposures that are immaterial in terms of size and perceived risk profile.

- Article 152 of the CRR details criteria for the risk weighting of exposures underlying collective investment undertakings (CIUs). In certain circumstances, an augmented SA can be used for the underlying exposures. However, permission to use the SA under Article 150 of the CRR is still required in these cases and the conditions according to which competent authorities may grant permission are to be specified in RTS.

Being able to apply the SA to certain exposures permanently, and implement the IRB approach for other exposures sequentially, does not constitute a new provision in the solvency framework. Articles 85, 87 and 89 of Directive 2006/48/EC previously provided for these possibilities in a similar (if not identical) manner.

Given that the three mandates (Articles 148(6), 150(3) and 152(5) of the CRR) and the proposed RTS for each of them are interrelated, Section 4 of this document presents a single legal text.

The subsections below summarise the rationale for the proposed policy choices.

Permanent use of SA

The conditions of application of Article 150(1)(a) to (c) of the CRR refer to the permanent use of the SA by IRB institutions. Given that the IRB Approach has been calibrated under the assumption that all exposures should be treated under that approach, except for the other cases contemplated in Article 150(1)(d) to (j) and Article 150(2) of the CRR, only two reasons can justify the combined use of both approaches on a permanent basis. On the one hand, the degree of risk associated with exposures treated under the SA should be limited. This should guarantee that the use of the SA by IRB institutions does not result in an underestimation of their required level of capital. On the other hand, the implementation of a rating system should not be unduly burdensome. This responds to the necessary efficiency of the IRB implementation and therefore is not related to the level risk underlying the exposures.

To specify these conditions, the EBA considers that a combination of quantitative and qualitative criteria ensures the desired objective and, at the same time, contributes to the harmonisation of the rules applied across the EU.

Quantitative criteria

The number of material counterparties should be limited for exposures to central governments/banks and institutions (Article 150(1)(a) and (b)). The EBA considered that a quantitative definition of the terms 'material' and 'limited' should be proposed. However, since a large number of immaterial counterparties can also lead to an excessive amount of risk in the exposure class, the EBA also considered setting a maximum amount of risk in the exposure class, defined in terms of both exposure value and risk-weighted exposure amounts.

In the more general case of business units and exposure classes or types of exposures (Article 150(1)(c)), they should be immaterial in terms of size and perceived risk profile to qualify for the permanent exemption. Consideration was given to setting an overall limit for the total

exposure level allowed under the SA, for sub-limits by exposure class/type of exposure/business unit and for a mixture of the two. An overall limit would be the least burdensome for institutions. In view of the 'size and perceived risk profile' criteria, the EBA considered that such limits should be set in terms of both exposure value and risk-weighted exposure amounts.

In all cases, the total amount eligible for the SA should be measured as a percent of the total level of exposure that should initially be treated under the IRB Approach (the 'set of relevant exposures'). Therefore, the categories of exposures already exempt under Article 150 should not be taken into account to limit the permanent use of the SA since they fulfil all the necessary criteria to be treated under this approach (e.g. the exposures to Member States that meet the requirements in Article 150(1)(d)). Only the definition of 'material' counterparty has been specified differently, i.e. in terms of eligible capital of the institution, because nothing suggests that it should be linked to the 'set of relevant exposures'.

The proposed thresholds will determine the maximum level of exposure (and risk-weighted exposure) that is allowed for IRB institutions to be eligible for the SA. When measured in terms of the 'set of relevant exposures', this maximum amount will be the same across all IRB institutions. However, when measured against other metrics (e.g. total balance sheet or the institution's total own funds), this will be directly linked to the specific circumstances of each institution.

Qualitative criteria

Qualitative criteria have been specified to determine whether the burden of implementing a ratings system would be justified by the potential benefits of doing so. These criteria refer to those features of the modelling process that determine the overall cost of the IRB implementation such as the technical and operational possibilities of developing a rating model. For the former, the information available for counterparties (which can be considered as representative of those in the exposure class) should be considered. For the latter, the cost of developing a ratings system (including the costs incurred in acquiring access to the relevant data) and the operational capacity of the institution should be relevant.

Exposures underlying CIUs

Article 152 (2) allows for a look-through approach under certain conditions. In this case, risk weights have to be calculated according to the underlying exposures of the CIU as if they were direct exposures of the institution.

Where the institution has received approval to apply the IRB Approach to the type of exposures to which the underlying exposures of the CIU belong, these underlying exposures should be treated under the IRB Approach (cf. Article 152(1) of the CRR). In this case, if the institution is allowed to use the SA permanently for that particular type of exposure, the underlying exposures of the CIU should also be risk-weighted in accordance to the SA. However, in these situations, these underlying exposures should also be taken into account when assessing compliance with the 'partial use' limit. Therefore, the rules proposed in these RTS for the application of

Article 150(1) of the CRR treat the underlying exposures of the CIU in the same way as the direct exposures.

Temporary use of the SA

The conditions that competent authorities (CAs) should consider when determining the appropriate nature and timing of the sequential roll-out plan under Article 148(3) of the CRR essentially refer to the need for institutions to avoid selectively choosing portfolios that would lead to a reduction in their total amount of own funds requirements.

Because of this, and as with the provisions which will be referred to the permanent use of the SA, the EBA considered that a combination of quantitative and qualitative criteria achieves the desired objective and, at the same time, helps harmonise the rules applied across the EU.

Quantitative criteria

The draft RTS propose a minimum level of exposures that must be under the IRB approach before permission for sequential roll-out can be granted. This threshold is considered to be the minimum amount that can mitigate the concerns of a potential underestimation of capital stemming from the combination of standardised and IRB Approaches. To aide this objective, the threshold has been specified not only in terms of exposure value but also in terms of risk-weighted exposure amount.

To ensure consistency with the RTS on the permanent use of the SA (all the exposures that do not fall under Article 150 of the CRR might have to be treated under the IRB Approach), this threshold has also been set in relation to the total level of exposures that should initially be treated under the IRB Approach ('set of relevant exposures').

Qualitative criteria

Between the initial minimum coverage ratio specified above and the final coverage determined by the provisions on the permanent use of the SA, institutions are allowed to temporarily have significant amounts of exposure under the SA until they can implement the corresponding ratings systems. Given that this situation may raise some concerns regarding a potential underestimation of capital as a result of a selective choice of the portfolios by the institutions, a number of qualitative criteria have been proposed in these RTS to mitigate them.

The first of these criteria is that competent authorities shall ensure that the higher the potential for underestimating the risks, the quicker this potential shall be reduced. For example, the potential for capital underestimation would be lower for institutions with a high initial degree of IRB coverage and CAs should take this into account when authorising their specific roll-out plan.

However, when the initial degree of coverage is lower, CAs should take the appropriate steps to guarantee that the roll-out plan does not represent any concern regarding the potential

underestimation of capital. This relates to the second criteria proposed in these RTS, which involve competent authorities ensuring that institutions have provided adequate reasons for including exposures at a later stage of their roll-out plan. Examples of these criteria might be the availability of data, the operational capability of the institution, the prior experience and time required to develop a ratings system and the existence of affiliate institutions in countries not subject to the CRR (or equivalent).

4. Draft regulatory technical standards on the sequential implementation of the IRB Approach and permanent partial use under the Standardised Approach under Articles 148(6), 150(3) and 152(5) of Regulation (EU) No 575/2013 (Capital Requirements Regulation – CRR)

COMMISSION DELEGATED REGULATION (EU) No .../..

of XXX

supplementing Regulation (EU) No 575/2013 of the European Parliament and of the Council with regard to the implementation of the sequential roll out

(Text with EEA relevance)

THE EUROPEAN COMMISSION,

Having regard to the Treaty on the Functioning of the European Union,

Having regard to Regulation (EU) No 575/2013 of the European Parliament and of the Council of 26 June 2013¹ on prudential requirements for credit institutions and investment firms and amending Regulation (EU) No 648/2012, and in particular Article 148 (6) thereof,

Whereas:

- (1) The calibration of the IRB approach for credit risk capital requirements has been made under the assumption that certain categories of exposures may be exceptionally treated under the SA on a permanent basis if certain conditions are met. Some of these conditions refer to the materiality of size and risk of the exempted exposures. In order to measure such degree of materiality, the set of relevant exposures should be identified.

¹

OJ L 176, p. 3.

- (2) In the case of exposures to ‘central governments and central banks’ and ‘institutions’, competent authorities may authorize the permanent use of SA if the number of material counterparties is limited. Since a large number of immaterial counterparties may also give rise to a large total exposure in each of these exposure classes, the permanent use of the SA should not only be dependent on the number of material counterparties but the consideration whether this number is sufficiently limited must also take into account the materiality of the total exposure value of the exposure class.
- (3) The permanent use of the SA in the case of exposures to ‘central governments and central banks’ and ‘institutions’ is also dependent on the cost of implementation of the ratings system. Those situations where technical or operational difficulties exist regarding the implementation of the IRB approach should also justify a permanent use of the SA.
- (4) In the more general case, non-significant business units and immaterial exposure classes and types of exposures may also be permanently treated under the SA if they can be considered as immaterial in terms of size and perceived risk profile. An overall limit to the total exposure value and to the total risk-weighted exposure amounts should restrict the permanent use of the SA while at the same time be the least burdensome on firms.
- (5) The permission for permanent partial use of the SA for specific exposure classes or types or business units may be extended by the competent authority to also capture such exposures when underlying to units or shares in a CIU held by institutions that calculate the risk weighted and expected loss amounts of these CIU exposures in accordance with Article 152 (2) (b) of Regulation (EU) 575/2013. Therefore, the rules proposed in this Regulation for the application of Article 150(1) of Regulation (EU) 575/2013 should treat the underlying exposures of the CIU in the same way as the direct exposures.
- (6) Institutions that have received permission to use the IRB approach may also temporarily use the SA if certain conditions are met. In particular, it has to be ensured that the use of the SA does not reflect a selective choice aimed at reducing the level of own funds requirements. Hence, there is a need to specify conditions on the appropriate nature and timing of the sequential roll out with a view to enable the competent authorities to determine, on the basis of their supervisory judgment, the appropriate design of that sequential roll out for institutions and any parent undertaking and its subsidiaries.
- (7) As an overall principle that should guide the design of the roll out plan, competent authorities should ensure that the higher the potential for underestimating the risks stemming from its design, the quicker this potential should be reduced.
- (8) As a minimum requirement, a specific amount of the set of relevant exposures should be required to be treated under the IRB Approach before any permission for sequential roll-out can be granted. This threshold should represent the minimum amount that can mitigate the concerns of a potential underestimation of capital

stemming from the temporary combination of SA and IRB approaches. To help this objective, the threshold should also be specified in terms of risk-weighted exposure amount.

- (9) Competent authorities should also ensure that institutions have provided adequate reasons for including exposures at a later stage of their roll-out plan. These situations may refer to the availability of data for modelling purposes, to the operational capability of the institution, to its prior experience and time required to develop a ratings system or to the existence of affiliate intuitions in countries not subject to the same (or equivalent) regulatory framework established by Regulation (EU) No 575/2013.
- (10) Failure to comply with any of the provisions contained in these RTS should be treated, as with any other non-compliance with any other IRB provision, under Article 146 CRR, which allows for all requirements under the IRB approach a temporary non-compliance if an institution provides a plan for a timely return to compliance and realises this plan within a period agreed with the competent authorities.
- (11) This Regulation is based on the draft regulatory technical standards submitted by the European Banking Authority to the Commission.
- (12) The European Banking Authority has conducted open public consultations on the draft regulatory technical standards on which this Regulation is based, analysed the potential related costs and benefits and requested the opinion of the Banking Stakeholder Group established in accordance with Article 37 of Regulation (EU) 1093/20102.

HAS ADOPTED THIS REGULATION:

Article 1 - General principles

1. For the purpose of application of this Regulation, the ‘exposure value’ of an exposure and the ‘risk-weighted exposure amount’ of an exposure shall be calculated by the institution in accordance with the approach which that institution uses for the calculation of its risk-weighted exposure amounts and its expected loss amounts and shall be the final figures, in particular after application of conversion factors and recognition of credit risk mitigation.
2. For the purpose of application of Article 150 (1) (a) and (b) of Regulation (EU) No 575/2013, the set of relevant exposures shall consist of all exposures of an institution, including those identified according to the provisions of Article 152 of Regulation (EU) No 2013/575 for exposures in the form of units or shares in CIUs, but excluding the exposures referred to in points (a) to (b) below:

²

OJ O, 331, p. 12

- (a) equity exposures as referred to in Articles 133(1) and 147(6) of Regulation (EU) No 575/2013;
 - (b) all exposures for which the institution has received permission to apply the Standardised Approach on the basis of Article 150(1) (d) to (f), (i) and (j) of Regulation (EU) No 575/2013;
3. For the purposes of application of Article 150(1) (c) of Regulation (EU) No 575/2013, the set of relevant exposures shall equal the set of relevant exposures determined in accordance with paragraph 2 above excluding all exposures for which the institution has received permission to use the Standardised Approach according to Article 150(1) (a) and (b) of Regulation (EU) No 575/2013.

Article 2 - Conditions of application of points (a) and (b) of Article 150(1) of Regulation (EU) No 575/2013

1. For the purpose of application of Article 150(1) (a) and (b) of Regulation (EU) No 575/2013, the number of material counterparties shall be deemed as limited for a certain exposure class if the following conditions are met:
- (a) the aggregate exposure value of all exposures assigned to this class does not exceed [8]% of the total exposure value of the set of relevant exposures referred to in Article 1 (2) above;
 - (b) the aggregate risk-weighted exposure amount of all exposures assigned to this class does not exceed [8]% of the total risk-weighted exposure amount of the set of relevant exposures referred to in Article 1(2) above;
 - (c) the number of material counterparties does not exceed [20]; for this purpose, a counterparty shall be considered as being material if the total exposure value of all exposures of the institution to this counterparty equals or exceeds [10%] of the eligible capital of the institution as determined by point (71) of Article 4(1) of Regulation (EU) No 575/2013.
2. For the purpose of application of Article 150(1) (a) and (b) of Regulation (EU) No 575/2013, implementing a rating system for counterparties in an exposure class shall be deemed as unduly burdensome on the basis of the following considerations:
- (a) the information available for counterparties representative of those in this exposure class;
 - (b) the cost to the institution of developing a rating system for counterparties in this exposure class (including costs incurred in order to acquire access to relevant data);
 - (c) the operational capability of the institution.

Article 3 - Conditions of application of point (c) of Article 150(1) of Regulation (EU) No 575/2013

For the purposes of application of Article 150 (1) (c) of Regulation (EU) No 575/2013, the application of the Standardised Approach shall be considered as being limited to classes or types of exposures that are immaterial in terms of size and perceived risk profile as well as to exposures in non-significant business units and the conditions that allow competent authorities to permit the application of the Standardised Approach according to Article 152(b) of Regulation (EU) No 575/201 shall be considered to be met, if both conditions below are met:

- (a) the total exposure value of all relevant exposures to which the institution currently applies the Standardised Approach is equal to or smaller than [8]% of the set of the relevant exposures referred to in Article 1(3);
- (b) the total risk-weighted exposure amount of all relevant exposures to which the institution currently applies the Standardised Approach is equal to or smaller than [8]% of the set of the relevant exposures referred to in Article 1(3).

Article 4 - Conditions according to which competent authorities shall determine the nature and timing of the sequential roll out

1. For the purposes of determining the appropriate nature and timing of the sequential roll out of the IRB Approach referred to in Article 148(3) of Regulation (EU) No 575/2013, competent authorities shall ensure that the higher the potential for underestimating the risks, the quicker this potential shall be reduced.
2. For the purposes of determining the appropriate nature and timing of the sequential roll out of the IRB Approach referred to in Article 148(3) of Regulation (EU) No 575/2013, competent authorities shall ensure that all the conditions below are met throughout the implementation of the sequential roll out plan:
 - (a) the total exposure value of all exposures for which permission to apply the IRB approach according to Article 143 of Regulation (EU) No 575/2013 has been received by the competent authority is equal to or larger than [50]% of the set of the relevant exposures referred to in Article 1(3) above;
 - (b) the total risk-weighted exposure amount of all exposures for which permission to apply the IRB approach according to in Article 143 of Regulation (EU) No 575/2013 has been received by the competent authority is equal to or larger than [50]% of the set of the relevant exposures referred to in Article 1(3) above.
3. For the purposes of determining the appropriate nature and timing of the sequential roll out of the IRB Approach referred to in Article 148(3) of Regulation (EU) No 575/2013, competent authorities shall ensure that institutions have provided adequate reasons for including in the IRB Approach a particular exposure class, business unit or use of own

estimates of LGDs and conversion factors at a later stage in accordance with their sequential roll out plan. Such reasons shall take into account the following considerations:

- (a) accurate, appropriate or complete time series data are not available.
- (b) the institution is not capable operational to immediately develop the rating system.
- (c) there is lack of sufficient prior experience.
- (d) the length of the time required for the development of the rating systems.
- (e) there are institutions affiliated to the institution and not subject to Regulation (EU) No 575/2013 or to equivalent third country's legislation.

Article 5 – Final provision

This Regulation shall enter into force on the twentieth day following that of its publication in the *Official Journal of the European Union*.

This Regulation shall be binding in its entirety and directly applicable in all Member States.

Done at Brussels,

For the Commission
The President

On behalf of the President
[Position]

5. Accompanying documents

5.1 Draft cost-benefit analysis/impact assessment

Definition of the problem

The CRR allows IRB institutions to permanently and/or temporarily use the SA for the calculation of their own funds requirements for credit risk under certain conditions.

In the case of the permanent use of the SA, most of these conditions have been fully specified in the CRR (cf. letters (d) to (j) Article 150(1) and paragraph 2 Article 150). However, other conditions referred to the immateriality of the portfolios and the cost of implementing the corresponding ratings systems have to be specified by the EBA in these draft RTS.

In the case of the temporary use of the SA, Article 148 of the CRR specifies the conditions of any sequential implementation of the IRB Approach across the different exposures. Through these draft RTS, the EBA specifies the conditions to be used by competent authorities when determining the appropriate nature and timing of any sequential roll-out plan. Other aspects such as the total length of the roll-out period, or the date until which IRB institutions should be able to calculate their capital requirements using the SA are at the discretion of the competent authorities.

Objectives

These RTS should contribute to a common understanding among institutions and the EU's national competent authorities of the conditions that can justify a permanent or temporary use of the SA by IRB institutions.

In the case of the permanent use of the SA, institutions are allowed to permanently handle under the SA those portfolios considered immaterial (both in terms of size and perceived risk profile) or too costly to be treated under the IRB Approach.

- Since the standardised and IRB approaches have been independently calibrated, competent authorities may have some concerns over IRB institutions using the SA due to a potential underestimation of own funds requirements unless the SA is applied to an immaterial set of exposures. These RTS should therefore specify which conditions should be met by the SA exposures of IRB institutions so that they can be considered as immaterial.
- As stated in Recital 42 of the CRR, '... the more risk-sensitive approaches require considerable expertise and resources as well as data of high quality and sufficient volume. Institutions should therefore comply with high standards before applying those approaches for regulatory own funds purposes. ...'. The exposure classes 'central governments and central banks' and 'institutions' are likely to fall under these considerations given the traditionally low number of defaults and limited number of counterparties. These RTS should specify under which

circumstances the implementation of the IRB Approach for these exposure classes can be considered too costly for the institutions and therefore not justified.

Regarding the temporary use of the SA, the same concerns described for the permanent use apply. In this case, however, it is not effective to restrict the temporary treatment only to a set of immaterial exposures. Therefore, these RTS should specify the conditions that should be taken into account by competent authorities when determining the nature and timing of the IRB roll-out sequence applied by institutions, so that the concerns related to the potential underestimation of the capital requirements are mitigated.

Technical options considered

This section explains the rationale behind the most relevant choices that the EBA made when designing the RTS proposals.

Set of relevant exposures

To establish the maximum level of exposures that can be treated under the SA by IRB institutions, the RTS propose a number of thresholds which are expressed as the 'set of relevant exposures'. This set excludes exposures that may be treated under the SA (given certain conditions) and therefore only includes the exposures that might have to be treated under the IRB Approach. By linking the use of the SA to the scope of application of the IRB Approach, it is ensured that the potential of capital underestimation is mitigated.

Alternatively, it was discussed whether these limits should have been expressed in terms of other metrics such as the institution's own funds or its total balance sheet exposure. It was concluded that these metrics do not accurately reflect the scope of application of the IRB Approach, and therefore are not suitable to address the concerns of a potential underestimation of capital. In addition, they might mean that some institutions would not be required to implement the IRB Approach at all if they already had a very significant level of exposures treated under the SA. This is due to the provisions of Article 150, which are not addressed by these RTS (Article 150(1)(d) to (j) and Article 150(2)).

Permanent use of the SA for 'central governments and central banks' and 'institutions'

In the case of exposures to central governments/banks and institutions (Article 150(1)(a) and (b)), these draft RTS define the terms 'limited' and 'material' in reference to the number of counterparties in the exposure class.

It was discussed whether or not to include the overall threshold of 8% as part of the definition of 'limited number of material counterparties'. The conclusion was that not doing so might lead to a situation where an exposure class that is significant because of a large amount of immaterial exposures (and not due to its material exposures) might have to be treated under the SA, which is not the intention of the CRR.

The provisions regarding the definition of ‘unduly burdensome’ are of a qualitative nature. It was decided that no quantitative requirements should be specified because it would be difficult to determine the technical conditions that would justify not implementing a ratings system for these exposure classes.

Permanent use of the SA for immaterial exposures

The insignificance of business units, immateriality of exposure classes and types of exposures has been addressed with an overall threshold (relative to the set of relevant exposures). Under this proposal, the total set of exposures that fall under this threshold is considered as immaterial for capital underestimation. This approach has the benefit of being clear and easy to implement across the different jurisdictions and should therefore increase the comparability of the solvency framework.

Explanatory box for consultation purposes

As an alternative to the proposed approach, the overall threshold could be complemented by an analysis of the immateriality/non-significance of the different types of exposures, exposure classes and business units that fall under this overall threshold. If the result of this analysis were that all these subsets of exposures could be considered as immaterial/non-significant, a higher overall threshold might be justified.

A second alternative was also discussed in which the overall threshold could be changed depending on whether the specific circumstances of the institution mitigate or aggravate the likelihood of underestimating the risk.

Proposal 1: Flexibility based on mandatory quantification of the potential likelihood of underestimating of the risk by directly identifying the difference between SA and approximated IRB capital requirements

Competent authorities may grant permanent partial use up to 15% of exposures if it can be proven that there is no underestimation of the risk. Exposures that cumulatively amount to less than 8% are considered immaterial in terms of size and perceived risk profile, and within this 8% threshold, authorities have flexibility to allow for permanent partial use, given that the exposures on aggregate is assessed to be immaterial.

However, if the 8% threshold is not sufficient, competent authorities must perform a risk analysis of the portfolios under the SA to identify whether the potential for underestimation of credit risk is still immaterial, i.e. whether these portfolios are still immaterial, not only in terms of size, but also in terms of the perceived risk profile. This risk analysis requires the competent authorities to calculate the IRB capital requirements for **all** exposures under the SA using reasonable proxies, which can be derived from following list:

- external ratings;

- internal non-approved estimates of risk parameters;
- historical default rates and losses;
- third-party vendor estimates;
- estimates from similar portfolios from other institutions ('benchmarks').

This IRB capital requirement must be compared to the corresponding capital requirement under the SA. If the total capital requirement under the SA does not show signs of material underestimation, i.e. higher, similar or only immaterially lower capital requirements, then the 8% threshold can be increased with the size of this portfolio. However, since the IRB Approach is more risk sensitive than the SA, this assessment needs to be regularly updated. This is because a future increase in risk profiles of portfolios under the SA might result in approximated IRB capital requirements then indicating a material underestimation of risk to the extent that that the current assumption is no longer valid.

The use beyond the 8% threshold should not be automatic, but be additional to the requirements, that the portfolios only have to apply for portfolios in insignificant business units or portfolios that are immaterial in terms of size and perceived risk profile, as stipulated in the CRR. Therefore it should be supplemented by additional qualitative criteria that ensure that competent authorities do not go beyond the 8% threshold, unless they can justify that specific circumstances warrant this. These circumstances will need to be defined clearly and in relation to the business.

Therefore, in general, competent authorities should not go beyond the 8% threshold, unless specific circumstances warrant this. However, if this is the case, the increase cannot take place unless the abovementioned risk analysis shows, on an on-going basis, that the perceived risk profile is adequately covered by the SA, or that an inadequate coverage is not substantial. Extraordinarily, these specific circumstances include many small portfolios (that are unsuited to the IRB models), low default or other portfolios, which the competent authority believe to be inadequately modelled under the IRB Approach, provided, however, that the effect of exempting these exposures is, in total, still immaterial in terms of size and the perceived risk profile as stated in the CRR.

The proposal can be supplemented by other criteria that can be used as an alternative; however, this must be clearly specified in the RTS. These can build on some of the principles listed below, i.e. the use of fixed LGDs, which would reduce the need to use the 8% or increase the 8% threshold if a PD/LGD approach is used on equities.

Proposal 2: No comparison between the SA and the approximate IRB capital requirements is required. Instead, there is the flexibility to consider the contribution of mitigating or aggravating circumstances regarding the potential underestimation of risk in the calibration of the thresholds that determine immateriality exposures in terms of size and perceived risk profile.

Competent authorities may allow adjustments to the calibration of the thresholds for size and the perceived risk profile for a particular institution, up to a maximum of 15%, and subject to a floor of 0% from the 8% threshold. This is only permitted if it is deemed necessary to reflect specific circumstances that, for this institution, increase or reduce the total potential for underestimating credit risk. To provide sufficient standardisation and to avoid arbitrary use, the list of allowed adjustments need to be exhaustive and the methods of adjustment need to be quantitatively specified. The following three types of adjustments would be allowed.

1. *Take into account an additional existing potential for underestimation of credit risk that results from combining more risk sensitive IRB methods with less risk sensitive IRB methods within the same class of exposures.*

Quantification: simultaneously reduce the thresholds for size and perceived risk profile by the percentage of exposures under the IRB Approach, for which a less risk-sensitive IRB method is used compared to the IRB method used for other exposures within the same exposure class or sub-class. This refers in particular to the percentage of supervisory LGDs used when combined with LGD estimates for other exposures (e.g. reduce the thresholds from 8% to 6% if supervisory LGDs are used for 2% of the exposures to which the institution applies the IRB Approach).

2. *Acknowledge the reduced potential for underestimating credit risk, which results from choosing models based on IRB methods instead of fixed IRB risk weights (also necessary for encouraging institutions to increase their models-based approaches).*

Quantification: simultaneously increase the thresholds for size and perceived risk profile by the percentage of exposures under the IRB Approach that use an internal models-based IRB method, instead of an IRB method for the same type of exposures that use fixed risk weights. This refers in particular to equity exposures or for specialised lending (e.g. increase the thresholds from 8% to 11% if the PD/LGD approach is used instead of the simple risk-weights approach for equity exposures for 3% of the exposures that the institution applies the IRB Approach to).

3. *In assessing whether the thresholds are met, acknowledge circumstances where an institution provides a better measure of the perceived risk profile of exempted exposures than the risk-weighted exposure amounts under the SA.*

Quantification: for the ratio of the perceived risk profile, calculate the risk-weighted exposure amounts for the exposures which the SA is applied to, by assuming that the IRB Approach was applied to these exposures, and provided that the institution is using risk-parameter estimates which are sufficiently conservative for these exposures, (exposures that the institution has demonstrated to be broadly in line with IRB minimum requirements). This requires that institutions have non-approved (but nevertheless broadly compliant) internal PD estimates available, which goes beyond the requirement in paragraph 6, and is typically only applicable where an institution is using internal rating systems for its internal risk management, but does not meet all the necessary minimum requirements for also using these internal rating systems to determine capital requirements under the IRB Approach (e.g. risk-weighted exposure amounts

based on a risk weight of 100% under the SA are replaced by risk-weighted exposure amounts under the IRB Approach, based on PD = 1% and LDG = 20% if these risk parameter have been demonstrated by the institution to have been estimated broadly in line with IRB minimum requirements, and to form a conservative proxy for a particular type of exposures of this institution).

Temporary use of the SA

As described in Section 3, the concern about a potential underestimation of capital, which stems from the combination of the standardised and IRB Approaches, is the main basis for these RTS.

The proposed initial IRB coverage ratio (i.e. 50%) represents the minimum amount that can mitigate these concerns. To specify the conditions that CAs should consider regarding the nature and timing of the rest of the sequence, several options have been discussed in addition to the option proposed.

One option consisted of specifying an interim IRB coverage ratio. This ratio would have a similar nature as the initial IRB coverage ratio proposed in these RTS, and therefore should be specified in terms of both exposure value and risk-weighted exposure amount, and as a percentage of the set of relevant exposures. The key aspects of this interim ratio would refer to the level of IRB coverage that should be attained and the specific date where this should happen (e.g. 'X'% of the set of relevant exposures should have been rolled out within the first 'N' years since the first IRB permission). This option was finally discarded because it was felt that it would conflict with the discretion granted by the CRR for CAs to specify the total length of the roll-out period, as it would affect the total design of the roll-out plan (including the total time period over which an institution would be required to implement the IRB Approach for all exposures).

A second alternative discussed establishes a link between the increase in the exposure value and the risk-weighted exposure amount treated under the IRB Approach at all points in time. This option would not affect the total length of the roll-out period, which is at the discretion of the competent authorities, and would also guarantee that institutions would not make selective choices with the purpose of reducing the level of own funds requirements. However, this option was considered to lack the necessary degree of flexibility required for the sequential implementation of the IRB Approach within an institution.

As a result of these difficulties to further impose quantitative requirements for the design of the roll-out plan, these RTS propose a more qualitative approach consisting of:

- a high-level principle according to which competent authorities should take the appropriate actions to reduce, in a timely manner, any potential for underestimating the risks;
- a set of reasons that justify the inclusion of exposures at a later stage of their roll-out plan.

Level of application of the RTS

The level of application of the CRR articles referred to in these RTS is addressed in Articles 6, 7 and 11 of the CRR. These articles state that the requirements apply on both an individual basis and a consolidated basis where applicable, except where competent authorities have waived application on an individual basis in accordance with Article 7(1) of the CRR. Therefore, no specific provisions have been forecast in Section 4 of this document to specify different treatment of the requirements on an individual and consolidated basis.

Explanatory box for consultation purposes

As an alternative to the proposed approach, the EBA would welcome views as to how the quantitative thresholds contained within these technical standards should be structured. Two options have been identified:

1. apply identical quantitative thresholds on a consolidated basis and an individual basis for institutions that are not subject to consolidated own funds requirements, but separately defined quantitative thresholds on an individual basis for institutions that are subject to consolidated own funds requirements (where applicable);
2. individual quantitative thresholds for institutions that are subject to own funds requirements, defined in terms of the consolidated quantitative thresholds (where applicable i.e. institutions will be deemed to comply on an individual basis if, and only if, they comply on a consolidated basis).

The advantage of the option proposed in the RTS (i.e. application of identical quantitative thresholds on a consolidated and individual basis) is that it results in a level playing field for individual institutions in a given jurisdiction. However, application of these quantitative thresholds on an identical basis to all members of a group might inhibit competent authorities' ability to reach a joint decision under Article 20 of the CRR when the thresholds are met on a consolidated basis but not in individual institutions or vice versa, and might be considered as disproportionate to the policy objective of these RTS. This concern could be addressed through option 2, which would be consistent with the right of institutions to meet certain other IRB requirements on a consolidated basis only. Option 2 would arguably be sufficient to achieve the purpose of these RTS, i.e. that 'cherry-picking' should be prevented. However, option 2 would not create a direct link between the position of an individual institution and the quantitative threshold applied. Option 1 could provide an alternative way forward as it would allow different thresholds to be set, although these would need to be appropriately calibrated. This option would not however address the concern about consistency in the joint decision making process.

Impact of the proposals

Permission for IRB institutions permanently and/or temporarily to use the SA is not new in the prudential regulation of credit institutions. However, the need to adapt to a new set of technical standards so that the competent authority will permit them to use the SA will most likely affect some institutions.

Direct compliance costs

The costs derived from complying with this regulation will depend, firstly, on whether the competent authority has permitted the individual institution to apply the SA to its credit exposures, both on a permanent and a temporary basis.

As a second driver, where the use of the SA has been permitted, the extent to which this permission has been used will be depend upon the following.

- Regarding the permanent use of the SA, those institutions which have applied the IRB Approach to the vast majority of their credit exposures will most likely not be significantly affected by these RTS. The proposed rules allow up to 24% of the set of (IRB) eligible exposures to be exempted from IRB treatment under Article 150(1)(a) to (c) of the CRR (not cumulatively but 8% under each one), which should provide a sufficient degree of flexibility in implementing the IRB Approach.
- Regarding the temporary use of the SA, the minimum IRB coverage required according to the proposed legal text (i.e. 50%) should represent neither a concern for those institutions that have already received permission to use the IRB Approach nor an operational burden for those which are planning to apply for permission. Qualitative criteria that would justify postponing the roll-out of the IRB implementation are the product of the validation experience gained since the first implementation of IRB models under CRD I, and therefore should cover the main drivers of roll-out.

Clearly, in cases where the competent authorities have permitted larger shares of exposure to be treated under the SA than the ones implied by these RTS, the institutions would be expected to implement the necessary additional internal ratings models to comply with these RTS. In these cases, although the number of new ratings models to be implemented is not expected to be very high, the direct compliance costs will very much depend on the type of models that have to be developed.

Indirect capital costs

As explained in the paragraphs above, the implementation of these RTS is not expected to lead to a significant number of non-compliant EU IRB institutions. Therefore, the impact of these RTS in terms of additional capital requirements is not expected to be significant.

Furthermore, in cases where the degree of IRB implementation is not sufficient to allow compliance with the new rules proposed in these RTS, the increase in the capital impact is expected to be limited because it refers either to a low default portfolio (in the case of central governments/banks or institutions) or to an immaterial portfolio.

Benefits

The provisions proposed in these draft RTS are expected to increase significantly the level of harmonisation for IRB institutions using the SA. In addition, and importantly, these provisions should help reduce the variability of risk-weighted assets across EU banks. As identified in previous EBA reports reviewing the consistency of risk-weighted assets, a significant driver of variations in these assets is the different extent to which the SA is used by IRB banks.

5.2 Overview of questions for consultation

Q1: Do you agree with the proposed draft RTS regarding the sequential application of the IRB Approach?

Q2: Do you agree with the proposed draft RTS regarding permanent partial use of the Standardised Approach (SA) for the exposures specified in Article 150(1)(a) and (b) of the CRR?

Q3: Do you agree with the proposed draft RTS regarding permanent partial use of the SA for the exposures specified in Article 150(1)(c) of the CRR? Which of the two alternative proposals presented in the impact assessment section under 'Technical options considered' do you prefer?

Q4: Do you agree with the quantitative thresholds proposed in Articles 2(1), 3 and 4(2) of these draft RTS? If not, what thresholds do you consider more suitable?

Q5: Do you think that separate quantitative thresholds should apply for application of these draft RTS on an individual and on a consolidated basis? Which of the two alternative proposals presented in the impact assessment section under 'Technical options considered' do you prefer?

Q6: Do you agree with our analysis of the impact of the proposals in this Consultation Paper? If not, can you provide any evidence or data that would explain why you disagree or which might assist our analysis of the possible impact of the proposals?