Council of the
European Union

Brussels, 25 April 2023
(OR. en)

8681/23

EF 115
ECOFIN 370
DELACT 52

COVER NOTE

From:	Secretary-General of the European Commission, signed by Ms Martine DEPREZ, Director
date of receipt:	20 April 2023
To:	Ms Thérèse BLANCHET, Secretary-General of the Council of the European Union
No. Cion doc.:	C(2023) 2571 final
Subject:	COMMISSION DELEGATED REGULATION (EU) …/... of 20.4.2023 supplementing Regulation (EU) No 575/2013 of the European Parliament and of the Council with regard to regulatory technical standards specifying the requirements for the internal methodology or external sources used under the internal default risk model for estimating default probabilities and losses given default

Delegations will find attached document C(2023) 2571 final.

Encl.: C(2023) 2571 final

EUROPEAN
COMMISSION

Brussels, 20.4.2023
C(2023) 2571 final

COMMISSION DELEGATED REGULATION (EU) …/...

of 20.4.2023

supplementing Regulation (EU) No 575/2013 of the European Parliament and of the Council with regard to regulatory technical standards specifying the requirements for the internal methodology or external sources used under the internal default risk model for estimating default probabilities and losses given default

(Text with EEA relevance)

EXPLANATORY MEMORANDUM

1. CONTEXT OF THE DELEGATED ACT

Article 325bp(12) of Regulation (EU) No 575/2013 ('the Regulation') empowers the Commission to adopt, following submission of draft standards by the European Banking Authority (EBA) in accordance with Articles 10 to 14 of Regulation No (EU) 1093/2010, delegated acts specifying the requirements that an institution's internal methodology or external sources are to fulfil for estimating probabilities of default (PDs) and losses given default (LGDs) in accordance with point (e) of paragraph 5 and point (d) of paragraph 6 of Article 325bp of the Regulation.

In accordance with Article 10(1) of Regulation No (EU) 1093/2010 establishing the EBA, the Commission shall decide within three months of receipt of the draft standards whether to endorse the drafts submitted. The Commission may also endorse the draft standards in part only, or with amendments, where the Union's interests so require, having regard to the specific procedure laid down in those Articles.

2. CONSULTATIONS PRIOR TO THE ADOPTION OF THE ACT

In accordance with the third subparagraph of Article 10(1) of Regulation No (EU) 1093/2010, the EBA has carried out a public consultation on the draft technical standards submitted to the Commission in accordance with Article 325bp(12) of the Regulation. A consultation paper was published on the EBA internet site on 22 July 2020 and the consultation closed on 22 October 2020. Moreover, the EBA requested the Banking Stakeholder Group set up in accordance with Article 37 of Regulation No (EU) 1093/2010 to provide advice on them. Together with the draft technical standards, the EBA has submitted an explanation on how the outcome of these consultations has been taken into account in the development of the final draft technical standards submitted to the Commission.

Together with the draft technical standards, and in accordance with the third subparagraph of Article 10(1) of Regulation No (EU) 1093/2010, the EBA has submitted its impact assessment, including its analysis of the costs and benefits, related to the draft technical standards submitted to the Commission. This analysis is available at https://www.eba.europa.eu/regulation-and-policy/market-risk/regulatory-technical-standards-rts-default-probabilities-and-losses-given-default-default-risk-model, pages 24-29 of the Final Report on the draft technical standards.

3. LEGAL ELEMENTS OF THE DELEGATED ACT

The final draft technical standards specify the requirements that an institution's internal methodology or external sources are to fulfil for estimating PDs and LGDs in accordance with point (e) of paragraph 5 and point (d) of paragraph 6 of Article 325bp of the Regulation. In particular, the requirements that an internal methodology needs to satisfy in order to estimate PDs and LGDs under the internal default risk model should encompass all the requirements applicable to the corresponding IRB approach (i.e. the requirements set out in Section 1 of Chapter 3 of Title II of Part Three of the Regulation). In addition, institutions have the possibility to use 'fallback' PD and LGD values under such an internal methodology, and the final draft technical standards set out alternative requirements ensuring that conservative 'fallback' PDs and LGDs are obtained, specifying also the conditions under which these 'fallback' PDs and LGDs can be produced and used. With respect to external sources, institutions are required, on the basis of these sources, to produce estimates of PDs and LGDs that are appropriate having regard to the institution's portfolio and that are validated on a periodic basis. In addition, where more than one external source is used, a hierarchy of sources shall be established in order to ensure the overall consistency of their use. The final draft technical standards also require that the methodology employed to derive the PDs and LGDs from the external sources is conceptually sound.

COMMISSION DELEGATED REGULATION (EU) …/...

of 20.4.2023

supplementing Regulation (EU) No 575/2013 of the European Parliament and of the Council with regard to regulatory technical standards specifying the requirements for the internal methodology or external sources used under the internal default risk model for estimating default probabilities and losses given default

(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 2013 on prudential requirements for credit institutions and amending Regulation (EU) No 648/2012[1], and in particular Article 325bp(12), third subparagraph, thereof,

Whereas:

(1) Article 325bp(5), point (e), and Article 325bp(6), point (d), of Regulation (EU) No 575/2013 require institutions that have not been granted permission to estimate default probabilities or losses given default in accordance with Part Three, Title II, Chapter 3, Section 1 of that Regulation for the purposes of calculating their own funds requirement for credit risk, to develop an internal methodology or to use external sources to estimate those default probabilities and losses given default for the purposes of calculating their own funds requirement for market risk referred to in Article 325bl of that Regulation. In order to ensure a level playing field across institutions in the Union, the requirements for such an internal methodology should be the same as those that apply to the methodologies used by institutions that have been permitted to estimate default probabilities or losses given default in accordance with Part Three, Title II, Chapter 3, of that Regulation. However, cases can be envisaged where, for the purposes of calculating their own funds requirement for market risk, institutions can neither rely on external sources of data, nor reasonably run their models in accordance with the requirements set out in Part Three, Title II, Chapter 3, of Regulation (EU) No 575/2013, due to the lack of input data or disproportionate effort required. Therefore, it is necessary to lay down specific requirements that enable the institutions' internal methodology used for the purposes of calculating the own funds requirement for market risk, or parts of it, to cover all such cases adequately. Those specific requirements should ensure prudent outcomes. At the same time, those requirements should meet specific needs in terms of timeliness and flexibility, including situations where positions for certain issuers are too small to require a complex methodology, and hence, a simpler methodology is more appropriate.

(2) Those specific requirements should only apply where necessary, that is, only where institutions can neither rely on external sources of data, nor reasonably run models satisfying the requirements set out in Part Three, Title II, Chapter 3, of Regulation

[1] OJ L 176, 27.6.2013, p. 1.

(EU) No 575/2013. Therefore, conditions should be laid down to ensure that there are no other sources for estimating default probabilities and losses given default, and that the cases in which institutions can neither rely on external sources, nor reasonably run their models do not represent an excessive amount of their portfolios considering the requirements laid down in Article 325bn(1) of Regulation (EU) No 575/2013. Institutions should assess those conditions frequently enough to take into account potential changes, including changes to the availability of external data sources, and considering the frequency with which the own funds requirements for market risk are reported.

(3) To enable institutions to take into account the characteristics of the positions for different issuers, including the materiality and holding periods of those positions, institutions should be allowed to develop internal methodologies for the estimation of default probabilities and losses given default which consist of different parts, to cover those different positions.

(4) It is necessary to ensure that the risk of default of individual issuers is sufficiently capitalised. The estimates of default probabilities and losses given default based on an internal methodology, or a part of it, should therefore be sufficiently conservative, having regard to other methodologies and sources used by the institutions. To that end, it is necessary to specify the conditions under which the estimates of default probabilities and losses given default will be sufficiently conservative. In particular, for those cases in which institutions can neither rely on external sources of data, nor reasonably run their models, limits should be set to the values that the estimates of default probabilities and losses given default may assume.

(5) Institutions that use external sources to estimate default probabilities and losses given default should, as part of the validation of the internal default risk model, periodically review the estimates produced to ensure that those estimates remain appropriate for the institutions' portfolios. Institutions that use more than one external source should establish a hierarchy of those external sources to ensure the overall consistency of their use in the internal default risk model. Furthermore, institutions that use external sources to estimate default probabilities may have to undertake a number of steps and procedures before they can produce the actual estimates of default probabilities. It is therefore necessary to lay down requirements to ensure that the methodology used to produce estimates of default probabilities from external sources is conceptually sound in that it produces accurate and consistent estimates that are not biased.

(6) Article 325bp(11) of Regulation (EU) No 575/2013 requires institutions to document their internal models so that their correlation assumptions and other modelling assumptions are transparent to the competent authorities. To assist competent authorities in ensuring compliance with that requirement, it is necessary to specify how that general documentation requirement is to be applied to internal methodologies or external sources used under the internal default risk model for estimating default probabilities and losses given default.

(7) This Regulation is based on the draft regulatory technical standards submitted to the Commission by the European Banking Authority.

(8) 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 advice of the Banking

Stakeholder Group established in accordance with Article 37 of Regulation (EU) No 1093/2010 of the European Parliament and of the Council[2],

HAS ADOPTED THIS REGULATION:

Article 1

Requirements for the internal methodology for estimating default probabilities

1. An institution's internal methodology, or a part of it, used for estimating default probabilities in accordance with Article 325bp(5), point (e), of Regulation (EU) No 575/2013, shall fulfil the same requirements as those that apply to the methodologies used by institutions that have been permitted to estimate default probabilities in accordance with Part Three, Title II, Chapter 3 of that Regulation.

2. By way of derogation from paragraph 1, an institution's internal methodology, or a part of it, for estimating default probabilities shall fulfil the requirements set out in paragraphs 3 or 4, as applicable, where, for a given issuer, all of the following conditions are met on a quarterly basis:

   (a) no external sources fulfilling the requirements set out in Article 2 are already available for estimating default probabilities for that issuer;

   (b) the use of an internal methodology, or a part of it, fulfilling the requirements set out in paragraph 1 is either:

      (i) not feasible due to a lack of input data for that issuer; or

      (ii) disproportionate in relation to the materiality or the holding period of the relevant positions for that issuer, based on the trading strategy adopted for such positions;

   (c) the value of 'm', calculated in accordance the formula laid down in paragraph 5, is any of the following:

      (i) lower than or equal to 10 %;

      (ii) higher than 10 %, and the institution carries out all of the following:

         (1) the institution investigates whether additional external sources fulfilling the requirements set out in Article 2 are available and uses those sources to reduce the value of 'm' to a value which is lower than or equal to 10 %;

         (2) the institution conducts a sensitivity and scenario analysis to assess the qualitative and quantitative soundness of the internal methodology or part of it.

   For the sensitivity analysis referred to in point (c)(ii)(2), the institution shall assess the sensitivity of the own funds requirements calculated in accordance with Article 325bn(1) of Regulation (EU) No 575/2013 in relation to all trading book positions referred to in Article 325bl of that Regulation. The institution shall do so by assigning to the issuers covered at the time of the calculation by the internal methodology or part of it, which fulfils the requirements set out in paragraphs 3 or 4,

---

[2] Regulation (EU) No 1093/2010 of the European Parliament and of the Council of 24 November 2010 establishing a European Supervisory Authority (European Banking Authority), amending Decision No 716/2009/EC and repealing Commission Decision 2009/78/EC (OJ L 331, 15.12.2010, p. 12).

as applicable, one rating grade higher than and one rating grade lower than the one used to fulfil the requirements set out in those paragraphs.

3. Where the conditions set out in paragraph 2 are met, an institution's internal methodology, or a part of it, shall assign to an issuer an estimate of default probability which is equal to or higher than the maximum of the following values:

(a) the highest default probability assigned to investment grade issuers of positions under the scope of the institution's internal default risk model and for which the conditions set out in paragraph 2 are not met;

(b) the equally weighted average of default probabilities assigned to issuers of positions under the scope of the institution's internal default risk model and for which the conditions set out in paragraph 2 are not met.

For the purposes of point (b), institutions may exclude defaulted issuers when calculating the equally weighted average of default probabilities, where they can ensure that the conditions set out in paragraph 2 are not met for such defaulted issuers.

4. By way of derogation from paragraph 3, where the conditions set out in paragraph 2 are met and the own funds requirements for default risk decrease as the value of default probability assigned to a given issuer increases, an institution's internal methodology or a part of it shall assign to that issuer an estimate of default probability which is equal to or lower than the value assigned in accordance with paragraph 3, point (b).

5. For the purposes of paragraph 2, point (c), institutions shall calculate the value of 'm' in accordance with the following formula:

$$\mathrm{m} = \frac{\mathrm{DRC(full\ scope)} - \mathrm{DRC(other\ methodologies\ and\ external\ sources)}}{\mathrm{DRC(full\ scope)}},$$

where:

DRC(full scope) = the own funds requirements calculated in accordance with Article 325bn(1) of Regulation (EU) No 575/2013 on the full scope of the trading book positions referred to in Article 325bl of that Regulation;

DRC(other methodologies and external sources) = the own funds requirements calculated in accordance with Article 325bn(1) of Regulation (EU) No 575/2013 relating exclusively to the trading book positions referred to in Article 325bl of that Regulation for the issuers of which the conditions set out in paragraph 2 are not met.

Article 2

Requirements for external sources for estimating default probabilities

1. When using external sources for estimating default probabilities in accordance with Article 325bp(5), point (e), of Regulation (EU) No 575/2013, institutions shall, in accordance with Articles 325bj(2) and 325bp(7) of that Regulation, validate the estimates of default probabilities on a periodic basis for their use in the internal default risk model.

2. Institutions shall obtain the estimates of default probabilities from external sources by employing a methodology that is conceptually sound and that fulfils the requirements set out in paragraph 4.

3. Institutions that use more than one external source shall establish a hierarchy of those external sources.

4. Before applying the floor referred to in Article 325bp(5), point (a), of Regulation (EU) No 575/2013, institutions shall ensure that the methodology referred to in paragraph 2 of this Article fulfils all of the following requirements:

(a) the methodology, based on the obligor grade scale used, where that scale could also be continuous, shall provide estimates of default probabilities corresponding to the applicable time horizon referred to in Article 325bp(5), point (b), of Regulation (EU) No 575/2013 that meet all of the following conditions:

(i) the estimates of default probabilities are considered accurate for all obligor grades having analysed their expected range of estimation errors;

(ii) the estimates of default probabilities are consistent across obligor grades;

(iii) the estimates of default probabilities provide a meaningful differentiation of risk and strictly increase as the creditworthiness of the obligor decreases;

(iv) the values of the estimates of default probabilities are not set to zero for an obligor grade solely on the basis that no defaults have been observed in the past for that obligor grade.

(b) where the methodology's estimates of default probabilities are not derived in combination with current market prices, institutions shall analyse any differences they observe between those estimates and estimates that are derived in combination with current market prices, as referred to in Article 325bp(5), point (c), of Regulation (EU) No 575/2013.

Article 3

Requirements for the internal methodology for estimating losses given default

1. An institution's internal methodology, or a part of it, used for estimating losses given default in accordance with Article 325bp(6), point (d), of Regulation (EU) No 575/2013 shall fulfil the same requirements as those that apply to the methodologies used by institutions that have been permitted to estimate losses given default in accordance with Part Three, Title II, Chapter 3 of that Regulation.

2. By way of derogation from paragraph 1, an institution's internal methodology, or a part of it, for estimating losses given default shall fulfil the requirements set out in paragraphs 3 or 4, as applicable, where, in relation to a given position, all of the following conditions are met on a quarterly basis:

(a) no external sources fulfilling the requirements set out in Article 4 are already available for estimating losses given default for that position;

(b) the use of an internal methodology, or a part of it, fulfilling the requirements set out in paragraph 1 is either:

(i) not feasible due to a lack of input data for that position; or

(ii) disproportionate in relation to the materiality or the holding period of that position, based on the trading strategy adopted for that position;

(c) the value of ‘m’, calculated in accordance with the formula laid down in paragraph 5, is any of the following:

(i) lower than or equal to 10 %;

(ii) higher than 10 %, and the institution investigates whether additional external sources fulfilling the requirements set out in Article 4 are available and uses those sources to reduce the value of ‘m’ to a value which is lower than or equal to 10 %.

3. Where the conditions set out in paragraph 2 are met, an institution’s internal methodology, or a part of it, shall assign to a position an estimate of loss given default which is equal to or higher than the following:

(a) 75 % for subordinated debt positions;

(b) 45 % for senior unsecured debt positions;

(c) 11,25 % for covered bond positions;

(d) 25 % for any other positions.

4. By way of derogation from paragraph 3, where the conditions set out in paragraph 2 are met and the own funds requirements for default risk decrease as the value of loss given default assigned to a given position increases, an institution’s internal methodology, or a part of it, shall assign to that position an estimate of loss given default which is equal to or lower than the values set out in paragraph 3.

5. For the purposes of paragraph 2, point (c), institutions shall calculate the value of ‘m’ in accordance with the formula set out in Article 1(5), where the term DRC (other methodologies and external sources) represents the own funds requirements calculated in accordance with Article 325bn(1) of Regulation (EU) No 575/2013 relating exclusively to the trading book positions referred to in Article 325bl of that Regulation for which the conditions set out in paragraph 2 are not met.

Article 4

Requirements for external sources for estimating losses given default

1. When using external sources for estimating losses given default in accordance with Article 325bp(6), point (d), of Regulation (EU) No 575/2013, institutions shall, in accordance with Articles 325bj(2) and 325bp(7) of Regulation (EU) No 575/2013, validate the estimates of losses given default on a periodic basis for their use in the internal default risk model.

2. Institutions that use more than one external source shall establish a hierarchy of those external sources.

Article 5

Documentation

1. Institutions whose internal methodology, or a part of it, meets the conditions set out in Article 1(2) or Article 3(2), shall, in relation to all the issuers and positions covered under those Articles, document all of the following:

(a) that no external sources fulfilling the requirements set out in Article 2 or in Article 4, as applicable, are available for estimating default probabilities for those issuers and losses given default for those positions, respectively;

(b) that the use of an internal methodology fulfilling the requirements set out in Article 1(1) for estimating default probabilities for those issuers, or in Article 3(1) for estimating losses given default for those positions, respectively, would not be feasible due to a lack of input data, or that it would be disproportionate in relation to the materiality or the holding period in line with the trading strategy adopted for those issuers or positions;

(c) the values of 'm', calculated in accordance with the formulae laid down in Article 1(5) and Article 3(5).

2. Institutions shall keep an up-to-date inventory of the external data sources used for the purposes of Articles 2 and 4, which shall contain all of the following:

(a) a description of the methodologies used to obtain estimates of default probabilities from external sources in accordance with Article 2(1) and Article 2(2);

(b) documentation and underlying rationale where an institution has identified different terms, information or assumptions in accounting for expected credit losses and the estimates of default probabilities from external sources for exposures under the internal default risk model for the purpose of ensuring sound credit risk management, as approved by senior management;

(c) a description of the methodologies used to obtain estimates of losses given default from external sources in accordance with Article 4(1);

(d) the results of the validation performed in accordance with Article 2(1) and Article 4(1);

(e) the hierarchy of the external sources used, in accordance with Article 2(3) and Article 4(2).

For the purposes of point (a), where the estimates of default probabilities differ from those used in the institutions' internal risk management methodologies and those differences are not due to the requirements set out in Article 325bp(5) of Regulation (EU) No 575/2013, those differences shall be part of the description of the methodologies.

For the purposes of point (c), where the estimates of losses given default differ from those used in the institutions' internal risk management methodologies and those differences are not due to the requirements set out in Article 325bp(6) of Regulation (EU) No 575/2013, those differences shall be part of the description of the methodologies.

Article 6

Entry into force

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 the Member States.

Done at Brussels, 20.4.2023

For the Commission
The President
Ursula VON DER LEYEN