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MR/MM

EACB comments on
EBA Guidelines
on proportionate retail diversification methods under Article 123(1) of Regulation (EU) No 575/2013

General comments

The EACB welcomes the opportunity to comment on the EBA Guidelines on proportionate retail diversification methods under Article 123(1) of the CRR3. We agree on the importance to define proportionate retail diversification methods for the application of a preferential risk wight of 75% and implement the **discretion embedded in the Basel III reforms to determine appropriate methodologies, beyond the 0.2% aggregate portfolio threshold**.

While generally setting the 0.2% threshold, the Basel III standards allowed supervisors to determine "*another method to ensure satisfactory diversification of the regulatory retail portfolio*". In its policy advice on Basel III reforms, the EBA stated that "*the proposed granularity criterion of 0.2% of the overall regulatory retail portfolio is neither necessary nor sufficient for ensuring adequate diversification of institutions' regulatory retail portfolios.*"

The draft Guidelines thus propose a two-step process whereby, in the first step, the institution identifies the eligible retail exposures that exceed 0.2% of their retail portfolio and, in a second step, the institution assesses whether the sum of the exposure values of the exposures identified in the first step is less than or equal to 10% of the sum of exposure values of all exposures in the portfolio of eligible retail exposures. However, the **diversification test as currently delineated in the draft Guidelines appears burdensome, not in line with the principle of proportionality and ineffective**, considering the limited benefits in terms of financial stability and the large expected impact on regulatory capital. While we can understand that quantitative criteria may allow to more easily compare different banking portfolios, **the current framework based on qualitative and quantitative criteria implemented at national level has shown to be effective and fit for purpose**. It also represents the appropriate compromise to account for specificities of financial institutions, without generating additional inappropriate costs. Therefore, we invite the EBA to a more thorough analysis of the diversification test, also in light of the severe effects on capital ratio that these requirements might have, particularly on small and medium banks.

Finally, we would like to remark that the draft guidelines will introduce an avoidable competitive disadvantage for small banks and their ability to finance the real economy because of a general reduction of the working capital, also for the SMEs loans. For example, a bank that only has a retail portfolio of EUR 100 million would be able to grant retail loans of up to EUR 200.000 granularly. This leads to strong distortions of competition to the disadvantage of small banks and, thus, contrasting the level playing field concept and the principle of proportionality. For this reason, an impact assessment based on a voluntary ad hoc data collection complementing the data of this Consultation might be beneficial to ensure a deeper understanding of the implications of the proposals elaborated in the EBA Guidelines.

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Answers to selected questions

Q1: What is the percentage of exposures within your retail portfolio that are part of a group of connected clients?

In terms of proportionality, there is an aspect that should be taken into account in the evaluations: smaller banks often have a higher number of connected clients relative to the total portfolio. This represents an additional disadvantage, as it results in lower granularity of exposures compared to larger banks.

Q2: Do you identify any implementation issue in implementing the diversification test?

The diversification test proposed in the draft Guidelines does not fully reflect the intent of the legislators to implement the principle of proportionality in defining the retail diversification methods under Article 123(1) of Regulation (EU) No 575/2013.

According to the draft Guidelines, the same diversification test would be applied to institutions regardless of their size. The proposed thresholds could force small banks to exclude loans exceeding the established limits from their retail portfolios, further reducing their size (in a feedback loop process). This would negatively impact small banks' ability to grant credit. It is therefore necessary to develop different solutions which take the principle of proportionality into account.

In our view, higher thresholds or greater flexibility (e.g., maintaining a qualitative criteria and gradual exemptions for very small banks with a balance sheet total lower or equal EUR 2.5 bn) should be devised, ensuring that institutions of all sizes can maintain a diversified portfolio without compromising their business model. Currently, a single exposure exceeding 0.2% could have a disproportionate impact in terms of capital requirements for smaller portfolios. It is important to underline that the proposed calibration in the Basel framework does not take into consideration small banks and, therefore, the threshold established cannot be considered satisfactory or proportionate. In any case, the guiding principle should be that for a smaller balance sheet total, the relief should be proportionally higher.

Another solution might be to define an absolute figure of retail exposures, appropriately reflecting the wording of Article 123(1)(c) of the CRRIII, i.e. “the exposure represents one of a significant number of exposures”. The threshold amount could, for instance, be set at 1,000 retail facilities, which would imply that a single exposure corresponds to 0.1% on average. Should an institution or a group fall below the absolute threshold, in this instance 1,000 retail facilities, then the proposed 0.2%/10% diversification test should be applied.

Regarding members to an institutional protection scheme (IPS) pursuant to Article 113(7) CRR, it might be considered sufficient to ensure a diversified retail portfolio on the level of an IPS, reducing the burden and the impact to the single institution.

Regardless of the final approach chosen, **it should be clarified in the guidelines that the retail portfolios in terms of exposure value shall be calculated before credit risk adjustments as gross amounts**. Similarly, it needs to be clarified if the diversification test should be applied in case of newly established and growing or a spin-off retail portfolio. In section “3.1 Proportionality” of the Consultation Paper, the only reference is made to the concentrated portfolios of smaller institutions and that cannot cover the specifics of the mentioned cases, as those are of a temporary nature and driven by the portfolio development (scale up or down) and not by its characteristics.

From an operational point of view, implementing the draft guidelines would increase the administrative burden and resource allocation for small and non-complex banks. This would stem from the need to implement more sophisticated monitoring systems and restructure portfolios to meet diversification thresholds. Such burdens would be disproportionate compared to the expected benefits and affect the level playing field for small and non-complex banks. In addition, the EBA should clarify how these calculations will be reported to the national competent authorities. For example, the information regarding the implementation of the previous threshold of 1% under Basel II was managed by the PUMA database in Italy. Confirmation of this aspect could impact the actual operational complexity for banks.

We would like to stress that the proposed methodology would have unreasonable costs for those institutions which apply a consistent and comprehensive approach to segmentation of exposures, where segmentation is regarded as one system determining not only the respective category in regulatory reporting, but also holistic risk management throughout the whole lifecycle of the exposure. Considering that risk management framework encompasses various process, e.g. marketing and sales activities, data collection, credit decision process, monitoring, default treatment, collection, etc., it would require re-segmentation of some part of exposures from retail to corporate at the beginning of the exposure lifecycle, to ensure that those exposures are channeled through the corresponding non-retail/corporate processes. Moreover, this would lead to further operational burden during exposure segmentation, where correct segment assignment would be additionally dependant on the current composition of the portfolio at the specific reference date of the prudential requirements. It would also lead to the situations where exposures with similar characteristics and reduced risk are to be treated in a non-homogeneous manner.

Further complexity is added by the requirement to carry the assessment at each level of consolidation for which minimum own funds requirements are calculated. Since test results may vary depending on the level of consolidation where the test is performed, determining the (sub-)consolidation level driving the segmentation would reveal challenging. In addition, it is not clear whether the EBA expects that such exposures should migrate there and back between retail and corporate segments at each reference date of the prudential requirements reporting, depending on the current composition of the portfolio.

Additionally, while we acknowledge that the EBA mandate to specify the diversification method solely relates to the retail exposures under Standardised approach, the effects of the proposed method on the IRB banks shall be considered. The definition of retail exposure under IRB approach also requires that they each represent one of a significant number of similarly managed exposures (article 147(5)(d)). Commission Delegated Regulation 2002/439 with regard to regulatory technical standards for the IRB assessment methodology further specifies that, when determining whether the criteria laid down in Article 147(5)(c) and (d) of Regulation (EU) No 575/2013 are met, competent authorities shall examine whether the assignment of exposures is consistent with the institution's business lines and the way those exposures are managed. IRB banks rather treat exposures, in terms of segmentation and risk management framework, including applicable credit policies and underwriting criteria, in the same way irrespective of whether those exposures are under IRB or Standardised approach. Therefore, the need to fulfil regulatory requirements towards segmentation of exposures under Standardised approach would influence segmentation under IRB approach as well, as separation of risk management frameworks depending on the approach would undermine robust and effective risk management.

Finally, **it would be important to include a phase-in period before the full implementation of a suitable diversification test**. Although the requirement is already included in the CRR III, the current methods implemented to ensure a proportionate retail diversification portfolio are much different from the expectations indicated in the draft Guidelines. Banks need time to adapt to new requirements, especially when these involve significant changes to their operating models.

Q3. Which methods do you currently use to assess retail diversification? Please elaborate.

Members have reported that different methods are currently in place. They range from the application of the 0.2% criterion to qualitative criteria. Members have also reported the application of absolute threshold value of 10,000 retail facilities to identify a significant number of retail exposures in accordance with Article 123(1)(b) of the CRR3. This diversity enables institutions with different business models and in different markets to determine the appropriate granularity threshold (which is in any case monitored by the supervisor). The use of qualitative cut-off criteria, as established in risk management frameworks including retail credit policies and underwriting criteria, ensures that small and medium-sized institutions treat the loans remaining in the retail portfolio in a standardised manner. These criteria specify types of standard retail mass products which are not managed as individually as corporate exposures. They also ensure flexibility and stability. The flexibility is needed to account for specificities related to different sizes of the institutions and their portfolios, macroeconomic rationale, different market environments the institutions operate in, specific lending and product mix or business strategy.

Q4. Under the proposed approach, in the first step of the calculation before any exclusion, what is the share in terms of exposure value of the large eligible retail exposures as defined under the proposed approach compared to all the eligible retail exposures?

NA

Q5. What is the impact of the proposed diversification assessment set out in these Guidelines compared to the diversification assessment that you currently perform on your retail portfolio?

From an operational point of view, the proposed diversification test would result in unnecessary complexity of exposure classification. As a consequence of implementing and monitoring the proposed diversification test, institutions across the EU are likely to incur unnecessary costs without necessarily adding any value from a prudential compliance standpoint.

Regarding the impact on the own fund ratio, in particular, the methods provided for in the draft will negatively affect the allocation to the retail business portfolio and thus on the core business of these institutions. This is particularly true for small and medium-sized institutions.

The tables below show the effects to institutions from two different sets of institutions, on data at 31.12.2023 as provided by members:

Jurisdiction A

	Institute 1	Institute 2	Institute 3
Today's diversification criterion			
Balance sheet total (€ million)	82	187	352
Retail portfolio (€ million)	30.4	85.1	145.6
Of which loans to SMEs (€ million)	14.5	28.4	30.3

Own funds ratio	23.07 %	20.81 %	17.60 %
Iterative approach			
Exclusion of loans to SMEs (€ million)	12.6	20.5	16.7
Exclusion of loans to natural persons (€ million)	7.5	21.7	31.3
Remaining volume retail portfolio (€ million)	10.3	42.9	97.6
Delta volume remaining retail portfolio	33.88%	50.41%	67%
Own funds ratio	20.58 %	19.10 %	16.82 %
Variation of the own fund ratio	-2.49%	-1.71%	-0.78%
Alternative approach			
Exclusion of loans to SMEs (€ million)	12.8	18.6	18.2
Exclusion of loans to natural persons (€ million)	8.8	28.2	37.4
Remaining volume retail portfolio (€ million)	8.8	38.3	90.0
Delta volume remain retail portfolio	28.95%	45%	61.81%
Own funds ratio	18.93 %	18.90 %	16.70 %
Variation of the own fund ratio	-4.14%	-1.91%	-0.9%

Jurisdiction B:

	Today	Iterative approach		Alternative approach	
			Delta		Delta
Small cooperative bank					
Own funds	16,530,490	16,530,490	0	16,530,490	0
EAD retail	45,360,592	0	-45,360,592	10,072,782	-35,287,810
RWA	87,982,599	97,857,423	9,874,824	95,532,359	7,549,760
TCR	18.79%	16.89%	-1.90%	17.30%	-1.48%
Medium cooperative bank					
Own funds	114,255,732	114,255,732	0	114,255,732	0
EAD retail	147,671,449	0	-147,671,449	92,888,848	-54,782,601
RWA	535,800,110	568,903,068	33,102,958	547,729,608	11,929,498
TCR	21.32%	20.08%	-1.24%	20.86%	-0.46%
Large cooperative bank					
Own funds	216,413,802	216,413,802	0	216,413,802	0
EAD retail	266,073,887	224,914,066	-41,159,821	232,867,031	-33,206,856
RWA	807,641,054	815,830,073	8,189,019	814,169,875	6,528,821
TCR	26.80%	26.53%	-0.27%	26.58%	-0.21%
Central body of local network					

Own funds	474,309,318	474,309,318	0	474,309,318	0
EAD retail	161,694,187	0	-161,694,187	101,102,797	-60,591,390
RWA	2,154,834,721	2,187,695,203	32,860,482	2,167,158,993	12,324,272
TCR	22.01%	21.68%	-0.33%	21.89%	-0.13%

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