Risk Accounting Standards Board's Response

to the Consultation Paper on Draft RTS for Assessing Material Model Changes

(EBA/CP/2024/24/December 9th, 2024)

Introduction

The Risk Accounting Standards Board (RASB) welcomes the opportunity to respond to the European Banking Authority's (EBA) consultation on the draft Regulatory Technical Standards (RTS) for assessing the materiality of extensions and changes under the Internal Ratings-Based (IRB) Approach.

Given the increasing complexity of model governance and regulatory compliance, we advocate for the integration of risk accounting principles to enhance transparency, accuracy, and risk oversight in model change assessments.

Risk Accounting enhances the integrity of financial risk assessments by providing a structured, quantifiable approach to evaluating all non-financial risks, including model risk.

By introducing a standardized unit of measure - the Risk Unit (RUs), Risk Accounting enhances transparency, ensuring that model changes are systematically assessed against regulatory requirements.

This method aligns with supervisory expectations, helping financial institutions validate model modifications and integrate their potential for risk exposure, while maintaining compliance with both the evolving risk landscape and the regulatory frameworks.

Understanding Risk Accounting

Risk Accounting enhances traditional model risk management by adding the capability of directly integrating standardized, quantitative risk information into financial and regulatory compliance reporting. This approach reduces reliance on historical financial and loss data and subjective assessments, offering a structured methodology that aligns with regulatory expectations. It also enables institutions to systematically track, compare, and report risk exposures in a structured and transparent manner.

This structured methodology allows for integrating the management all non-financial risks, strengthens governance, enhances regulatory compliance, and ensures model risk assessments are aligned with supervisory expectations.

How It Works:

1. **Risk Units (RUs):** Risk exposures are quantified into standardized Risk Units, enabling comparability across different risk categories and financial institutions.

2. **Integration into Model Governance:** Institutions embed Risk Accounting into their risk management frameworks, aligning with regulatory requirements such as Basel IRB standards.

3. **Dynamic Monitoring:** Risk Accounting enables continuous tracking of exposure changes, ensuring model adjustments reflect real-time risk conditions.

4. **Regulatory Compliance:** By using a structured approach, institutions improve transparency and auditability, simplifying supervisory reviews and reducing compliance risks.

The Role of Risk Accounting in Supporting the Draft RTS

Risk accounting provides a standardized approach for quantifying and managing non-financial risks by integrating them into financial metrics while recognizing their distinct nature.

Non-financial risks, such as operational, conduct, and reputational, as well as model risks, are measured separately using Risk Units (RUs) to ensure a structured and consistent assessment. This differentiation allows institutions to account for non-financial risks effectively while aligning with regulatory expectations and enhancing transparency in model governance.

However, institutions may find more direct applicability in referencing model risk governance frameworks such as Basel IRB standards or EBA model validation guidelines to address the consultation paper's specific requirements.

While effective data aggregation supports transparency, a more direct reference to model risk governance frameworks might be more suitable for addressing the requirements of this consultation.

The use of Risk Units (RUs) facilitates objective measurement and comparison of risk exposures, aligning with the principles outlined in the Basel Framework and the BCBS 239 standards for effective risk data aggregation and reporting.

1. **Standardized Measurement of Risk-Weighted Exposure Amount (RWEA) Impact**
    - Risk accounting enables institutions to quantify the financial impact of changes in rating systems with greater precision. The introduction of RUs can serve as an additional metric for evaluating whether a model change breaches materiality thresholds.
    - By integrating risk accounting into the calculation of risk-weighted exposure amounts, financial institutions can enhance the comparability of internal models, improving alignment with regulatory expectations.
2. **Improving Risk Data Aggregation and Transparency**
    - While BCBS 239 emphasizes the importance of robust risk data aggregation and reporting, its direct relevance to model change assessment under the RTS framework should be carefully considered. Institutions may benefit more from aligning their approaches with regulatory requirements specific to model risk governance and validation. Risk accounting ensures that model changes are recorded in a structured and traceable manner, reducing the risk of inconsistencies in regulatory submissions.
    - The systematic quantification of non-financial risks associated with model changes enhances transparency, aiding regulatory authorities in assessing systemic risks stemming from material modifications.
3. **Facilitating Model Extensions and Calibration**
    - The draft RTS outlines the conditions under which model extensions require approval. Risk accounting can assist institutions in demonstrating the robustness of extensions by providing structured risk assessments.

- The structured quantification of RUs, as explored in RASB's recent research, enhances model calibration by providing institutions with a standardized approach to measuring and comparing risk exposures. This approach ensures that adjustments to rating systems align with regulatory thresholds and supervisory expectations, improving both transparency and regulatory compliance.

Key Recommendations

To ensure the effective integration of risk accounting principles within the RTS framework, we propose the following refinements:

1. **Incorporation of Risk Units (RUs) in Materiality Assessments**
    - Institutions could be encouraged to use risk accounting metrics alongside traditional quantitative thresholds to assess the impact of model changes on RWEA.
    - This would allow for a more granular and transparent assessment of the systemic implications of model modifications.
2. **Enhanced Risk Reporting and Data Aggregation Requirements**
    - Institutions could be required to demonstrate how changes in rating models impact aggregated risk data and overall exposure levels.
    - Regulatory authorities could adopt standardized reporting templates leveraging risk accounting methodologies to facilitate consistent supervisory assessments and, most importantly, comparability among market players.
3. **Alignment with Basel Framework**
    - Risk accounting could be recognized as an enabler of compliance with the Basel Framework's risk sensitivity requirements.
    - The RTS could reference risk data aggregation and reporting principles where relevant to ensure alignment with global best practices.

Response to Consultation Questions

Wha Risk Accounting does is to introduce an abstraction capability that enhances the application of both the **quantitative and qualitative criteria** for assessing materiality by aligning model changes with specific materiality thresholds outlined in the RTS.

By systematically structuring risk components into standardized Risk Units (RUs), institutions can quantitatively assess the impact of model modifications against regulatory benchmarks. This approach ensures that both minor and significant changes are transparently evaluated, improving the accuracy and consistency of materiality assessments within regulatory expectations.

This enables institutions to systematically categorize and measure various risk factors, facilitating a more objective and transparent assessment of model changes.

The integration of RUs supports regulatory compliance by aligning model governance with industry standards, ensuring a structured methodology for evaluating materiality thresholds and risk-weighted exposure adjustments

Question 1: Do you have any comments on the clarification of the scope of the revised draft regulatory technical standards to specify the conditions for assessing the materiality of the use of an existing rating system for other additional exposures not already covered by that rating system and changes to rating systems under the IRB Approach?

Response: The clarified scope provides much-needed guidance on defining materiality in the use of existing rating systems for additional exposures and model changes. However, further specificity regarding the threshold criteria for materiality assessments would improve regulatory clarity. It is our belief that institutions require a structured framework to assess the risk implications of these expansions.

Challenges: The proposed approach may lead to inconsistencies in determining materiality, as the reliance on qualitative judgments could increase supervisory burden and ambiguity for institutions.

Impact on the Industry: The lack of a standardized quantitative assessment approach may lead to varying interpretations, making cross-institutional comparisons difficult.

How Risk Accounting Can Help: Risk Accounting introduces a quantitative method through the use of Risk Units (RUs) to objectively measure the materiality of new exposures under an existing rating system. This allows for a structured comparison of exposure impacts across different rating segments, aligning with regulatory expectations while reducing subjective interpretation.

Question 2: Do you have any comments on the clarifications and revisions made to the qualitative criteria for assessing the materiality of changes as described in Annex I, part II, Section 1 and Annex I, part II, Section 2?

Response: The revisions to the qualitative criteria introduce greater flexibility but in our perception also raise concerns regarding the subjectivity of materiality assessments. Institutions would benefit from additional regulatory guidance on applying these criteria consistently.

Challenges: The absence of standardized quantification tools may lead to inconsistencies across institutions, making it difficult for supervisors to objectively benchmark and compare assessments.

Impact on the Industry: The increased reliance on judgment-based assessments could introduce compliance risks and complicate regulatory reporting and result processing for a comprehensive market level view.

How Risk Accounting Can Help: Risk Accounting provides a structured framework to assess qualitative materiality criteria by mapping risk changes into RUs. This ensures that qualitative assessments are converted into measurable risk factors, enhancing comparability and regulatory alignment.

Question 3: Do you have any comments on the clarifications and revisions made to the qualitative criteria for assessing the materiality of extensions and reductions as described in Annex I, Part I, Section 1 and Annex I, Part I, Section 2?

Response: The refinements in assessing materiality for model extensions and reductions improve transparency but may still pose challenges in practical implementation. Institutions would benefit from clearer thresholds for defining significant versus minor extensions.

Challenges: A lack of precise guidance on when an extension or reduction qualifies as material may increase regulatory uncertainty.

Impact on the Industry: Variability in assessment criteria may lead to regulatory fragmentation across different jurisdictions.

How Risk Accounting Can Help: By leveraging RUs, Risk Accounting introduces an objective method to evaluate extensions and reductions. This structured approach allows financial institutions to consistently measure the impact of changes on risk exposure and capital requirements, reducing ambiguity.

Question 4: Do you have any comments on the introduced clarification on the implementation of the quantitative threshold described in Article 4(1)(c)(i) and 4(1)(d)(i)?

Response: The introduction of a clear quantitative threshold provides a structured approach to assessing materiality, but additional granularity on its application may be necessary.

Challenges: The fixed threshold approach may not account for institution-specific risk profiles and business models.

Impact on the Industry: A rigid threshold may disproportionately impact smaller institutions with limited diversification options, compared to larger institutions.

How Risk Accounting Can Help: Risk Accounting offers a dynamic approach by aligning RUs with capital adequacy measures, ensuring that threshold calculations reflect actual risk exposure levels rather than arbitrary percentage thresholds.

Question 5: Do you have any comments on the revised 15% threshold described in Article 4(1)(d)(ii) related to the materiality of extensions of the range of application of rating systems?

Response: The revised 15% threshold is a reasonable benchmark for assessing materiality but should consider adjustments based on product portfolio risk profiles and historical performance.

Challenges: A uniform percentage threshold does not account for varying risk sensitivities across different asset classes.

Impact on the Industry: Institutions may need to recalibrate rating systems frequently to stay within compliance, increasing operational complexity and workload.

How Risk Accounting Can Help: Risk Accounting provides a structured mechanism to assess rating system extensions through RUs, allowing institutions to validate whether changes align with regulatory limits while considering risk-based factors.

Question 6: Do you have any comments on the documentation requirement for extensions that require prior notification?

Response: The requirement for prior notification is a positive step towards improving regulatory oversight but should be complemented with guidance on documentation expectations.

Challenges: The lack of standardized templates may result in inconsistent reporting, increasing compliance challenges.

Impact on the Industry: Institutions may struggle with added administrative burdens if documentation requirements are not clearly defined.

How Risk Accounting Can Help: Risk Accounting introduces a structured approach to documentation by integrating RUs into risk assessment reporting. This ensures that institutions provide regulators with consistent, auditable records that align with compliance expectations.

The RTS requires institutions to assess materiality based on quantitative and qualitative criteria. Risk accounting enables a structured methodology for

quantitatively measuring and documenting model changes using RUs, ensuring a comprehensive audit trail for supervisory review.

The use of risk accounting can streamline the validation process by providing standardized risk assessments across different models and business lines.

Practical Example: Using Risk Accounting to Adjust Models

This example aligns with the RTS framework by demonstrating how materiality thresholds, as outlined in Articles 4(1)(c)(i) and 4(1)(d)(i), can be systematically evaluated using Risk Units (RUs).

1. **Step 1: Identify the Model Change Requirements**
    - The bank's credit risk model currently underestimates risk exposure in volatile market conditions.
    - New regulatory guidelines require the inclusion of forward-looking risk estimates.
2. **Step 2: Apply Risk Units (RUs) for Assessment**
    - Using the risk accounting framework, the bank calculates the expected increase in risk-weighted assets (RWAs) due to the new adjustments.
    - Each non-financial risk factor, such as operational risks and systemic exposure, is quantified in Risk Units (RUs) to ensure comprehensive assessment, aligning with qualitative criteria in Annex I, Part II, Section 1 of the RTS.
3. **Step 3: Model Calibration and Risk Sensitivity Testing**
    - The revised model is tested by simulating different stress scenarios.
    - The accumulation of RUs is analyzed to ensure that the new model does not lead to excessive residual risk taking or violate materiality thresholds, ensuring compliance with Article 4(1)(d)(ii) regarding the 15% threshold.
4. **Step 4: Reporting and Compliance Alignment**
    - The adjustments and their impact on risk exposure are documented in standardized reporting templates.
    - Regulatory authorities review the RU-based model assessment to verify compliance with Basel standards and the RTS requirements. For example, in past supervisory reviews under Basel III guidelines, institutions have been required to provide comprehensive documentation of risk quantification methodologies, demonstrating alignment with regulatory thresholds. Additionally, the European Banking Authority (EBA) has emphasized the importance of transparency in risk model adjustments, ensuring that any extensions or modifications are backed by robust historical performance analysis.
5. **Step 5: Continuous Monitoring and Optimization**

- The bank integrates a real-time monitoring[1] system to track fluctuations in RUs, ensuring proactive adjustments to the credit risk model as market conditions evolve.
- A structured framework for Risk Units (RUs) is explored to improve transparency and auditability in regulatory submissions, ensuring that institutions maintain comprehensive records of risk exposures and model adjustments.

By adopting risk accounting principles in model adjustments, financial institutions can enhance model accuracy and regulatory compliance by applying a structured methodology to systematically and consistently assess model changes. This approach ensures that RU-based metrics are integrated into governance frameworks, validation processes, and reporting structures, improving consistency, transparency and alignment with regulatory expectations.

Conclusion

It is our firm belief that the integration of risk accounting principles within the RTS on material model changes could bring significant benefits, to both regulators and regulated, in terms of risk measurement accuracy, governance, and regulatory transparency.

We encourage and are ready to support the EBA in considering learning more about the risk accounting method that we propose, with the aim to enhance the effectiveness of supervisory assessments and improve the overall resilience of financial institutions' risk models.

[1] By "real-time" we understand at least required information availability the next day, virtually within the required time for effective decisions to be made before potential losses could occur.