European Banking Authority

EBA/CP /2024/22

12 November 2024

Consultation Paper

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

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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 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 12.02.2025. 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 reviewable 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 (EU) 1725/2018 of the European Parliament and of the Council of 23 October 2018. Further information on data protection can be found under the Legal notice section of the EBA website.

2. Executive Summary

1. The EBA is mandated under Article 123(1) of the CRR3 to issue Guidelines to specify, for the purpose of identifying retail exposures under the standardised approach of credit risk, proportionate retail diversification methods under which an exposure represents one of a significant number of exposures with similar characteristics, such that the risks associated with such exposure are substantially reduced, as required by Article 123(1)(c) CRR3 (diversification criterion). It is recalled this is one of the mandatory requirements for retail exposures to be granted a preferential risk weight of 75%[1], as opposed to being assigned a 100% risk weight for natural persons or being treated as a corporate in the case of SMEs (100% risk weight pre-SME supporting factor for unrated corporates).

2. The Basel III international standards allow sufficient granularity of the retail portfolio as one method to ensure satisfactory diversification of the regulatory retail portfolio, whereby no aggregate exposure to one counterparty can exceed 0.2% of the overall portfolio, with discretion given to national supervisors to instead determine another method to ensure satisfactory retail diversification. It is noted that the CRR3 mandate granted to the EBA specifies that the proposed methods are to be proportionate.

3. The EBA is consulting on an approach, whereby institutions not holding a granular enough portfolio following the Basel 0.2% criterion would still retain the possibility to be eligible for the preferential risk weight. Concretely, institutions with a less diversified portfolio, i.e. with exposures above the 0.2% criterion, will still be considered sufficiently diversified, as long as no more than 10% of their retail portfolio exceeds the 0.2% threshold. This ensures harmonisation across the EU and supervisory convergence through objective metrics, while ensuring simple methods commensurate to the size of the institutions and their retail portfolios.

[1] Except 1) transactor exposures, which are assigned a 45% RW and 2) exposures due to loans granted by an institution to pensioners or employees with a permanent contract against the unconditional transfer of part of the borrower's pension or salary to that institution, which are assigned a 35% RW, if to meeting the conditions set out in Article 123(4).

3. Background and rationale

4. These Guidelines address the mandate granted to the EBA under Article 123(1) of the CRR3 to specify proportionate diversification methods for retail exposures under which an exposure is to be considered as one of a significant number of exposures with similar characteristics, such that the risks associated with such exposure are substantially reduced. Satisfactory diversification is one of the mandatory requirements for retail exposures to be assigned the preferential retail risk weight, as set out under CRR Article 123 paragraphs 1 and 2.

5. The Basel III international standards allow sufficient granularity of the retail portfolio as one method to ensure satisfactory diversification of the regulatory retail portfolio, whereby no aggregate exposure to one counterparty is to exceed 0.2% of the overall portfolio, with discretion given to national supervisors to instead determine another method to ensure satisfactory retail diversification. The Guidelines are making use of this discretion.

3.1 Proportionality

6. Smaller institutions tend to have more concentrated retail portfolios than larger institutions. The diversification methods proposed in this consultation paper allow for institutions whose retail portfolio is not granular enough to still be eligible for the preferential risk weight, subject to meeting a diversification test where all the inputs are readily available for institutions.

7. The use of simple methods that require straight-forward inputs from institutions contributes to meeting the proportionality mandate, in line with recital 46 of the original CRR as of 26 June 2013[2], while ensuring harmonization in the EU and supervisory convergence through objective metrics[3].

3.2 Diversification test

8. The proposed diversification test requires an institution to compare the share of retail portfolio exposures that exceed the 0.2% granularity threshold at the level of group of connected clients (GCCs) in the retail portfolio against a given threshold.

[2] Extract from recital 46 of CRR: “The provisions of this Regulation respect the principle of proportionality, having regard in particular to the diversity in size and scale of operations and to the range of activities of institutions. Respect for the principle of proportionality also means that the simplest possible rating procedures, even in the Internal Ratings Based Approach ('IRB Approach'), are recognised for retail exposures.”

[3] The draft Consultation Paper accordingly takes into account the guidance received from the EBA Advisory Committee on Proportionality, in particular the recommendations for 2024 in the credit risk area so that the guidance it delivers are drafted in a way that is consistent with and uphold the principle of proportionality without damaging the prudential objectives. EBA Work programme 2024 (europa.eu)

9. The **scope of retail exposures** under assessment for ensuring diversification are the retail exposures as already characterized under CRR article 123 paragraphs (1) and (2). Specifically, institutions shall:

   i. Identify the full set of exposures that meet the criteria set out in CRR Article 123 (1) points (a), (b) and (d)

   ii. Exclude any exposures as specified in CRR Article 123(2).

10. The retail diversification test is to be performed:

    a. Excluding defaulted retail exposures.
    b. For each reference date and at the level of application of the prudential requirements as required by the CRR. Specifically, the assessment is to be carried out at the level of consolidation for which minimum own funds requirements are calculated. Where minimum own funds requirements are calculated at the level of the individual institution, the exposures included in the assessment are those of the individual institution. In contrast, where minimum own funds requirements are calculated at consolidated level, the exposures included in the assessment are exposures of all entities included in the consolidated situation.
    c. At GCCs' level. It is recalled that institutions are already mandated to identify GCCs in the retail portfolio through the retail size criterion specified under CRR Article 123(1)(b). Hence, identification of such GCCs does not represent any additional burden for institutions[4].
    d. It is recalled that CRR Articles 124(1)(a), 125(1) last paragraph and 126(1) last paragraph specify that certain exposures secured by mortgages on immovable property shall be assigned the RW applicable to the unsecured exposures of the counterparty involved. Whenever that counterparty is retail, those exposures are to be assigned the appropriate risk weight based on the specifications of CRR Article 123. Hence those exposures secured by immovable property that are to be risk-weighted as retail shall also be subject to the retail diversification test, as this is required to assign the relevant retail risk weight.

Consultation box

Question for consultation

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

11. The **calculation** of the proposed diversification test follows an iterative approach:

    a. In the first step, the institution identifies the eligible retail exposures that exceed 0.2% of their retail portfolio at the level of GCCs. Eligible retail exposures are defined as

[4] RTS on identification on the group of connected clients

exposures that would qualify for a preferential risk weight for retail exposures if the diversification requirement set out in Article 123(1), point (c) of CRR is met.

b. 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. If this is the case, the whole portfolio is considered to be diversified. Otherwise, if the sum of the exposure values of the exposures identified in the first step exceeds the 10% threshold, then institutions may wish to exclude from the original retail portfolio some or all of the exposures identified in the first step and iterate the process.

c. Any excluded exposures will be risk-weighted according to Article 123 (4) of the CRR3 or as exposure to a corporate in the case the exposure is to a small and medium-sized entity-(SME)[5].

12. Once exclusions have been made, the institution should recalculate the 0.2% threshold and the sum of exposure values of exposures that exceed 0.2% of the eligible retail exposures, based on the portfolio post exclusions, and exclude once again exposures not meeting anymore the 10% threshold based on the new calculations considering the portfolio post-exclusions.

13. Institutions may apply this iterative process until a portfolio where the sum of the exposure values of exposures that exceed 0.2% of the portfolio under assessment is less than or equal to 10% of this portfolio, is identified. In this case, the portfolio resulting from the exclusion of exposures is considered diversified.

14. If no diversified portfolio is determined within the retail exposure class by the institution, all exposures have to be risk-weighted according to Article 123 (4) of the CRR3 or according to exposures to a corporate in the case the exposure is to an SME.

Question for consultation

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

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

EXPLANATORY BOX: Alternative approach considered

The EBA has also considered an alternative approach, whereby the calculation of the 0.2% threshold would be performed **only once** instead of an iterative process. Under this approach, the calculation would be carried out with reference to the portfolio before any exclusions are made. Specifically, this means that to compute the 0.2% threshold the denominator refers to the sum of the exposure values of those exposures in the **original portfolio**, i.e. without excluding

[5] Article 5 (9) of CRR3

any exposures above the 0.2% threshold. Under this calculation method, the associated threshold for the diversification assessment is proposed to be set at 5%.[6]

Mathematical formulation of the two options:

The key difference in the two options lies in the way of calculating if the portfolio has a material share of exposures that exceed the 0.2% threshold. This depends on whether removing the largest exposures results in recalculating the denominator accordingly (iterative approach) or not (one-step approach). Mathematically:

Option 1 – iterative approach:

Iteration 1 : $\frac{\sum_{i=1}^{n} EAD_i \times 1_{\left\{EAD_i / \sum_{i=1}^{n} EAD_i > 0.2\%\right\}}}{\sum_{i=1}^{n} EAD_i}$, to be compared with 10%

Subsequent iterations: $\frac{\sum_{i=1}^{m} EAD_i \times 1_{\left\{EAD_i / \sum_{i=1}^{m} EAD_i > 0.2\%\right\}}}{\sum_{i=1}^{m} EAD_i}$, to be compared with 10%

Option 2 – one-step approach: $\frac{\sum_{i=1}^{n} EAD_i \times 1_{\left\{EAD_i / \sum_{i=1}^{n} EAD_i > 0.2\%\right\}}}{\sum_{i=1}^{n} EAD_i}$, to be compared with 5%

With the following notation:

- EAD_i *is exposure value of the exposure i*
- *1 is an indicator function, which returns the value 1 for exposures exceeding the 0.2% threshold;*
- *n is the total number of exposures in the **original** retail portfolio, before any exclusions*
- *m is the total number of exposures in the **final** retail portfolio, after the exclusions*

Stylised example of proposed calculation methods

Subsets	**A**	**B**	**C**	**D**	***Total***
Number of exposures	360	500	10	50	*920*
Exposure value of each individual exposures	10€	20€	40€	200€	*/*
Total exposure value	3 600€	10 000€	400€	10 000€	*24 000€*

The first step is to calculate the 0.2% threshold and the maximum exposure values below which the whole portfolio is considered as diversified.

[6] For the same level of thresholds, the iterative approach is harder to pass than the one step approach. This is because, the iterative approach follows the same calculation of the one step approach in its first iteration, and then subsequently adds other tests in the form of other iterations. As a consequence, in order to make these approaches equivalent, the threshold for the one step approach must be more conservative (i.e. lower) than the threshold used under the iterative approach.

- In this original portfolio, any exposure exceeding 48€ will be above the 0.2% granularity (0.2% * total exposure value = 0.2%*24 000€ = 48€). Hence, the exposures in the subset D exceed the threshold of 48€. This first identification step in the calculation is common for both options 1 and 2.
- The maximum of the sum of the exposure values exceeding the 0.2% threshold defined in the previous step, below which the whole portfolio is considered as diversified is, for this first step:
  - 10% * 24 000€ = 2 400 € under option 1 – iterative approach
  - 5% * 24 000€ = 1 200 € under option 2 – one-step approach

Calculation under the alternative approach

Under the alternative approach (option 2 - one-step approach), subsets A, B and C are considered as diversified as they are below the 0.2% granularity given than they are below 0.2%*24 000€ = 48€, hence will be assigned the preferential retail RW. In addition, up to 5% of the exposures can exceed the 0.2% threshold. This means that up to 5% * 24 000€ = 1 200 € in subset D can be considered as diversified, which corresponds to 6 exposures. The 44 other exposures in subset D will however be excluded and not benefit from the preferential retail RW. No more calculations are necessary.

The portfolio eligible for the preferential risk weight following the alternative approach is as follows:

Subsets	A	B	C	D	*Total*
Number of exposures	360	500	10	6	*876*
Exposure value of each individual exposures	10€	20€	40€	200€	/
Total exposure value	3 600€	10 000€	400€	1 200€	*15 200€*

Calculation under the proposed approach

Under the proposed approach in the CP (option 1 - iterative approach), the 0.2% threshold and the maximum exposure values exceeding 0.2% below which the whole portfolio is considered as diversified should be recalculated after the exclusions.

In this case, similar calculations as performed in the alternative approach (same 0.2% threshold, but 10% threshold instead of 5%), lead to the exclusion of 38 exposures in subset D, as up to 10%*24 000 = 2 400 can exceed the 0.2% threshold, which corresponds to 12 exposures, hence 38 exposures are to be removed while 12 remain in subset D.

However, in comparison with the alternative approach, the thresholds should be recalculated on this new portfolio post exclusion:

Subsets	A	B	C	D	*Total*

Number of exposures	360	500	10	12	*882*
Exposure value of each individual exposures	10€	20€	40€	200€	*/*
Total exposure value	3 600€	10 000€	400€	2 400€	*16 400€*

Under this new portfolio post exclusion:

- The 0.2% threshold is recalculated as follow: any exposure exceeding 32.8€ will be above the 0.2% granularity (0.2% * total exposure value = 0.2%*16 400€ = 32.8€). Hence, the exposures in the subset C are now also exceeding the 0.2% threshold.
- The 10% threshold is recalculated as follow: The maximum exposure values below which the whole portfolio is considered as diversified is 10% * 16 400€ = 1 640€. This threshold is breached (400€ + 2400€ > 1640€), hence additional exposures should be excluded in order for the remaining portfolio to qualify for the preferential retail RW.

The final portfolio eligible for the preferential risk weight following the proposed approach is as follows:

Subsets	A	B	C	D	*Total*
Number of exposures	360	500	10	5	*875*
Exposure value of each individual exposures	10€	20€	40€	200€	*/*
Total exposure value	3 600€	10 000€	400€	1 000€	*15 000€*

To note, in this example, the outcome of the two options is similar: under the two options, subsets A, B and C can benefit from the preferential retail RW. In addition, 5 or 6 exposures from subset D can benefit from the preferential retail RW, under the iterative or the one-step approach respectively.

4. Draft guidelines

In between the text of the draft Guidelines that follows, further explanations on specific aspects of the proposed text are occasionally provided, which either offer examples or provide the rationale behind a provision, or set out specific questions for the consultation process. Where this is the case, this explanatory text appears in a framed text box.

European Banking Authority

EBA/GL-REC/20XX/XX

DD Month YYYY

Draft Guidelines

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

1. Compliance and reporting obligations

Status of these guidelines

1. This document contains guidelines issued pursuant to Article 16 of Regulation (EU) No 1093/2010[7]. In accordance with Article 16(3) of Regulation (EU) No 1093/2010, competent authorities and financial institutions must make every effort to comply with the guidelines.

2. Guidelines set the EBA view of appropriate supervisory practices within the European System of Financial Supervision or of how Union law should be applied in a particular area. Competent authorities as defined in Article 4(2) of Regulation (EU) No 1093/2010 to whom guidelines apply should comply by incorporating them into their practices as appropriate (e.g. by amending their legal framework or their supervisory processes), including where guidelines are directed primarily at institutions.

Reporting requirements

3. According to Article 16(3) of Regulation (EU) No 1093/2010, competent authorities must notify the EBA as to whether they comply or intend to comply with these guidelines, or otherwise with reasons for non-compliance, by [dd.mm.yyyy]. In the absence of any notification by this deadline, competent authorities will be considered by the EBA to be non-compliant. Notifications should be sent by submitting the form available on the EBA website with the reference 'EBA/GL/202x/xx'. Notifications should be submitted by persons with appropriate authority to report compliance on behalf of their competent authorities. Any change in the status of compliance must also be reported to EBA.

4. Notifications will be published on the EBA website, in line with Article 16(3).

2. Subject matter, scope and definitions

Subject matter

5. In accordance with Article 123(1) of Regulation No (EU) 575/2013 2013 as amended by Regulation (EU) 2024/1623 (CRR), these guidelines specify proportionate retail diversification

[7] 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).

methods under which an exposure is to be considered as one of a significant number of similar exposures as specified in point (c) of Article 123(1) of Regulation (EU) No 575/2013.

Scope of application

6. Competent authorities should apply these guidelines in accordance with the scope of application of Article 123(1) of Regulation (EU) No 575/2013.

Addressees

7. These guidelines are addressed to competent authorities as defined in Article 4 point (2)(i) of Regulation (EU) No 1093/2010 and to financial institutions as defined in Article 4(1) of Regulation (EU) No 1093/2010.

Definitions

8. Unless otherwise specified, terms used and defined in Regulation (EU) No 575/2013 have the same meaning in the guidelines.

Eligible retail exposure	Any exposure that, if the requirement set out in Article 123(1) point (c) of Regulation (EU) No 575/2013 is fulfilled, would be subject to the treatment set out in Article 123(3) or 123(5) of that Regulation.

3. Implementation

Date of application

9. These guidelines apply from dd.mm.yyyy

4. Proportionate retail diversification methods

10. For the purpose of Article 123(1), point (c) of Regulation (EU) No 575/2013, an exposure should be considered as representing one of a significant number of exposures with similar characteristics, such that the risks associated with such exposure are substantially reduced, where it is an eligible retail exposure and it belongs to a sufficiently diversified portfolio in accordance with paragraph 11.

11. A portfolio should be considered sufficiently diversified where the sum of the exposure values of the large eligible retail exposures, as defined in paragraph 12, does not exceed 10% of the sum of the exposure value of all the eligible retail exposures in the portfolio being assessed.

12. An eligible retail exposure should be considered a large eligible retail exposure when its exposure value exceeds 0.2% of the sum of the exposure value of all the eligible retail exposures in the portfolio being assessed. For the purpose of identifying large eligible retail exposures, the institution should treat the eligible retail exposures to a client or to a group of connected clients, as applicable, as a single exposure, summing their exposure values.

13. The institution should first assess whether the portfolio composed of all the institution's eligible retail exposures meets the condition set out in paragraph 11.

14. Where the portfolio composed of all the institution's eligible retail exposures does not meet the condition set out in paragraph 11, the institution may exclude from it one or more large eligible retail exposures as defined in paragraph 12.

15. The portfolio resulting from the exclusion of exposures carried out in accordance with paragraph 14 should be considered as sufficiently diversified if it meets the condition set out in paragraph 11.

16. The exposures excluded in accordance with paragraph 14 should not be considered as representing one of a significant number of exposures with similar characteristics for the purpose of Article 123(1), point (c) of Regulation (EU) No 575/2013.

Explanatory box

The EBA has also considered an alternative approach, whereby the calculation of the 0.2% threshold would be performed only once. Under this approach the calculation would be carried out by multiplying by 0.2% the sum of the exposure values of those exposures belonging to the **original portfolio**, i.e. to the portfolio without excluding any exposures above the 0.2% threshold.

Under this alternative approach, paragraphs 10 to 16 of the guidelines would be specified as follows, where the relevant changes compared with the proposed approach appear in underlined and in bold:

10. An exposure should be considered as representing one of a significant number of exposures with similar characteristics, such that the risks associated with such exposure are substantially reduced, for the purpose of Article 123(1), point (c) of Regulation (EU) No 575/2013, where it belongs to a sufficiently diversified portfolio in accordance with paragraph 11.

11. A portfolio should be considered sufficiently diversified where the sum of the exposure values of the large eligible retail exposures, as defined in paragraph 12, does not exceed <u>**5%**</u> of the sum of the exposure values of <u>**all the institution's eligible retail exposures**</u>.

12. An eligible retail exposure should be considered a large eligible retail exposure when its exposure value exceeds 0.2% of the sum of the exposure values of <u>**all the institution's eligible retail exposures**</u>. For the purpose of identifying large eligible retail exposures, the institution should treat the eligible retail exposures to a client or to a group of connected clients, as applicable, as a single exposure, summing their exposure values.

13. The institution should first assess whether the portfolio composed of all the institution's eligible retail exposures meets the condition set out in paragraph 11.

14. Where the portfolio composed of all the institution's eligible retail exposures does not meet the condition set out in paragraph 11, the institution may exclude from it one or more large eligible retail exposures as defined in paragraph 12.

15. The portfolio resulting from the exclusion of exposures carried out in accordance with paragraph 14 should be considered as sufficiently diversified if it meets the condition set out in paragraph 11.

16. The exposures excluded in accordance with paragraph 14 should not be considered as representing one of a significant number of exposures with similar characteristics for the purpose of Article 123(1), point (c) of Regulation (EU) No 575/2013.

Question for consultation:

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?

5. Accompanying document

Section 5.1 Draft cost-benefit analysis / impact assessment

15. Article 123(1) of Regulation (EU) No 575/2013 as amended by Regulation (EU) 2024/1623 (CRR) mandates the EBA to issue Guidelines to specify proportionate retail diversification methods under the Standardised Approach of credit risk under which the exposure shall be considered as one of a significant number of exposures with similar characteristics; satisfactory diversification is one of the mandatory criteria set out under Article 123(1) CRR to be fulfilled for the application of a preferential risk weight of 75%.[8]

16. As per Article 16(2) of the ESAs regulation (Regulation (EU) No 1093/2010, (EU) No 1094/2010 and (EU) No 1095/2010 of the European Parliament and of the Council), any guidelines developed by the ESAs shall be accompanied by an Impact Assessment (IA) in the annex which analyses 'the potential related costs and benefits' of the guidelines. Such annex shall provide the reader with an overview of the findings as regards the problem identification, the options identified to remove the problem and their potential impacts.

17. The EBA has prepared the IA contained in this consultation paper, which analyses the policy options considered. Given the nature of the topic, the IA is qualitative.

Problem identification and baseline scenario

18. The Basel III international accords determine the 'diversification condition' for retail exposures eligible to the 75% preferential risk-weight as the 'granularity criterion', where it is noted that no aggregate exposure to one counterparty can exceed 0.2% of the overall portfolio excluding defaulted exposures, unless the national supervisor has determined another method to ensure satisfactory retail diversification.

19. To retain the possibility for institutions that do not hold a granular enough retail portfolio to be eligible for the preferential risk weight, a diversification test is introduced that allows an objective quantitative assessment of no material correlation. The diversification test in its final, simplified version can be seen as a granularity test with additional flexibility, which does not impose significant additional burden on institutions, as it is based on already available information. In practice, institutions simply are to compare the share of their retail exposures that exceed the 0.2% granularity criterion to a pre-specified threshold. The exact calibration of the threshold is still subject to discussion and depends on the specific implementation of the calculation of the 0.2% granularity criterion, which serves as input for the correlation criterion.

[8] Except 1) transactor exposures, which are assigned a 45% RW and 2) exposures due to loans granted by an institution to pensioners or employees with a permanent contract against the unconditional transfer of part of the borrower's pension or salary to that institution, which are assigned a 35% RW when meeting the conditions set out in Article 123(5).

20. Larger institutions can be in a better position to have less concentrated retail portfolios, in case retail exposures are a relevant part of the business activities of this institution, and in such case are expected to meet the 0.2% granularity criterion more easily compared with smaller institutions. Thus, diversification concerns are limited for larger retail portfolios and the introduced measure is of particularly relevance and provides flexibility for those institutions with retail portfolios with obligors for which the total amount owed by all these obligors or groups of connected clients to the institution, its parents and its subsidiaries (other than for RRE) is lower than EUR 500mn.

Policy objectives

21. The main objective of these guidelines is to provide harmonized guidance at European level for appropriate retail diversification methods that are required to fulfil the mandatory criteria on satisfactory diversification in order for an exposure to be granted a preferential risk weight treatment and ultimately achieving a level playing field across the EU. In particular, this instrument should retain the possibility to be eligible for the preferential risk weight also for institutions that are not holding a granular enough retail portfolio the possibility to be eligible for the preferential risk weight.

Options considered

22. In preparing the present guidelines, the EBA considered two policy options:

   a. **Non-iterative process:** Multiplying 0.2% by the sum of the exposure values of those exposures belonging to the **original portfolio**, i.e. to the portfolio without excluding any (large) exposures;

   b. **Iterative process:** Multiplying 0.2% by the sum of the exposure values of those exposures belonging to the **final portfolio that is being assessed**, i.e. . the original portfolio after excluding any (large) exposures.

Assessment of the options and the preferred option(s)

23. Taking into account proportionality and ensuring strict prudential standards, the assessment considers (i) operational practicability, (ii) risk management incentives, and (iii) comparability across institutions.

24. Under Option a., exposures exceeding the 0.2% granularity criterion are retained in the denominator. The removal of exposures that exceed the 0.2% granularity criterion from the portfolio therefore automatically leads to satisfactory diversification. By applying a non-iterative process, the granularity criterion is only verified once, which avoids circular calculations in which the denominator always refers to the original portfolio from which no exposures have been removed:

   a. Concerning (i): this option can be considered as a proportionate and harmonised approach toward ensuring satisfactory retail diversification;

b. Concerning (ii): from a risk management perspective, this approach could incentivise the construction of artificially large non-granular retail exposures that inflate the denominator as reference is only made to the original portfolio. While incentives for such practices could be limited to a certain extent as the institution would have to bear the cost of such artificial exposure inflation in terms of RWEA, these capital costs might, however, rather not be sufficient for discouraging this regulatory arbitrage, due to being relatively minor compared to the reduction in capital costs for the difference between a 100% risk weight and the preferential retail risk weight, if unconditionally cancellable commitments with only 10% conversion factor are used for this purpose;

c. Concerning (iii): from a comparability perspective, the approach would treat the same portfolios differently for different banks, depending on the existence of excluded exposures, as the reference is always to the original portfolio. While excluding large eligible retail exposures allows bank A to treat the whole remaining portfolio as sufficiently diversified, this remaining portfolio might be identical with the original portfolio of another bank B which, however, would need to exclude additional large eligible retail exposures under Option a.

25. Under Option b., exposures exceeding the 0.2% criterion are removed from the denominator; put differently, the denominator is updated to reflect removed exposures and exposures, which will belong to the regulatory retail portfolio. The removal of exposures that exceed the 0.2% granularity criterion from the portfolio does therefore not necessarily lead to satisfactory diversification. For this reason (i.e. updating the denominator), the iterative nature of this option comes into play to determine the retail exposures that are eligible for the preferential risk-weight. Generally, it should be noted that, by construction, the resulting granularity is systematically higher with this option than with option a., as the denominator becomes smaller due to the iterative process:

   a. Concerning (i): this option can also be considered as a proportionate and harmonized approach toward ensuring satisfactory retail diversification, but its implementation is more complex due to the iterative process. However, since this approach is also based solely on readily available information, the additional burden can be deemed relatively modest;

   b. Concerning (ii) and (iii): from a risk management and comparability perspective, this option does not incentivise an artificial inflation of exposures and treats the same portfolios equally as the denominator takes into account the excluded exposures.

26. Consequently, the preferred option is **Option b.** as it ensures a proportionate and harmonized approach treating the same portfolios equally and ensures a prudent stance with a properly calibrated threshold toward a satisfactory retail diversification in order for exposures to be granted a preferential risk weight of 75% as set out under Article 123(1) CRR.

Question for consultation

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?

- Please fill in the amounts in the table below using as reference date end-2023 and please report the amounts in EUR millions. Please use the exchange rate as published in the Official Journal of the EU 29.12.2023 (C/2023/1403).

To ensure comparability between all the amounts provided, please report all the amounts using the CRR III rules as of 1st January 2025.

Breakdown by risk weight	Amounts applying current diversification methods		Amounts applying diversification methods as proposed in the Consultation Paper		Amounts applying the alternative diversification method as proposed in the explanatory box of the Consultation Paper (non-iterative)	
	EV	RWA	EV	RWA	EV	RWA
Preferential risk weight	To be filled in	To be filled in	To be filled in	To be filled in	To be filled in	To be filled in
Non-preferential risk	To be filled in	To be filled in	To be filled in	To be filled in	To be filled in	To be filled in

European Banking Authority

Overview of questions for consultation

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

Q2. Do you identify any implementation issue in implementing the diversification method?

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

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?

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?

- Please fill in the amounts in the table below using as reference date end-2023 and please report the amounts in EUR millions.
  To ensure comparability between all the amounts provided, please report all the amounts using the CRR III rules as of 1st January 2025.

Breakdown by risk weight	Amounts applying current diversification methods		Amounts applying diversification methods as proposed in the Consultation Paper		Amounts applying the alternative diversification method as proposed in the explanatory box of the Consultation Paper (non-iterative)	
	EV	RWA	EV	RWA	EV	RWA
Preferential risk weight	To be filled in	To be filled in	To be filled in	To be filled in	To be filled in	To be filled in
Non-preferential risk	To be filled in	To be filled in	To be filled in	To be filled in	To be filled in	To be filled in