

# POSITION PAPER



## **ESBG's response to the EBA consultation on the supervisory handbook for IRB systems validation**

**ESBG (European Savings and Retail Banking Group)**

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Dear Sir/Madam,

Thank you for the opportunity to comment on the European Banking Authority (EBA) consultation on its supervisory handbook for the validation of internal ratings-based systems. The European Savings and Retail Banking Group (ESBG) would like to provide you with the comments below, which we hope will be considered by the EBA.

### General comments:

**In ESBG's view, the organizational suspension of the validation function should be independent of the size of the bank.** It should be assessed based on criteria oriented toward the objective of objective validation decisions rather than formal organizational structures.

**In addition, it should ensure that the validation manual is free of inconsistencies with existing supervisory regulations.** In particular, the ECB Guide to Internal Models (General Topics, lit. 65) contains detailed expectations for validation. For example, specific advanced analyses will be performed every three years and will be the initial validation after each material model change. In our view, the EBA Validation Manual should be based on the ECB Guide to Internal Models rules. These guidelines have meanwhile proven their worth in practice. Instead of detailed organizational requirements, such as separate units for the operational execution of development and validation activities, it should generally ensure through organizational measures (including standardized control procedures) that development and validation activities are carried out free of conflicts of interest.

We believe that **it would also be helpful to consider the aspect of proportionality more closely.** The intensity and scope of validation activities must always be based on the expected data situation, the importance of the rating procedure, and the scope and complexity of the changes made.

The manual formulates a requirement [33] that the validation concept includes a description of the data collection process and selection of all data sets used for validation. At the same time, it is expected (Focus Box 1) that all types of data preparation steps are well documented in the validation report. It should instead clarify that **it is sufficient if the relevant documentation is available in one place and the appropriate references allow a clear picture of the data collection and preparation.**

### ESBG's response to the consultation's questions:

**Question 1a: How is the split between the first and the subsequent validation implemented in your institution? Please also state the reasons for your answer.**

The validation policy of some ESBG members envisages 3 types of validation activities: initial, full, and regular validation. An initial validation is a comprehensive and in-depth validation across all validation areas and tests, which is performed for any new models or material model changes. Full validation is performed every 3 years and regular validation is performed every year to cover all relevant aspects at the relevant frequency as defined in the European Central Bank (ECB) Guide to internal models (IM).

The split between the first and subsequent validation is defined as follows:

- First (initial) validation is conducted for the new models (roll-out to IRB) or material model changes;
- Subsequent validation is conducted on annual (regular validation) or every 3 years (full validation) basis to cover all changed as well as unchanged aspects of the model since last validation.

- The reason to assess non-material model changes within the annual validation (i.e. unchanged aspects in line with the section 5 and changed aspects with the section 4) after implementation is threefold:
- Internal validation comprehensively assesses materiality of any ex-ante and ex-post notification in line with the qualitative and quantitative criteria;
- Ex-ante and ex-post notifications have very limited impact on the RWA variability;
- Efficiency and comprehensiveness of the internal validation processes.

**Question 1b:** Do you see any constraints in implementing the proposed expectations (i) as described in section 4 for the first validation for a) newly developed models; and b) model changes; and (ii) as described in section 5 for the subsequent validation of unchanged models? Please also state the reasons for your answer.

For points (i) a) and (ii), we do not see any major constraints to implement expectations of the section 4 and section 5 respectively. However, we strongly believe that requirement to implement expectations of the section 4 for ex-ante or ex-post notifications in line with (Commission Delegated Regulation (EU) No. 529/2014 with regard to regulatory technical standards for assessing the materiality of extensions and changes of the Internal Ratings Based Approach), will increase inefficiencies and produce unduly burdensome in the assessments of the internal validation functions.

In the basic approach, the EBA for validation activities focuses on changed facts to check them intensively. For non-changed points, on the other hand, a system based on standard analyses is pursued. We welcome this approach in principle. However, the approach proposed by the EBA hardly differentiates between the materiality of models/portfolios and model changes in line with the proportionality principle. In our view, however, a fundamentally identical audit approach in the validation for all models that have not been changed and all types of model changes are not risk-adequate, i.e., differentiation should be made here in a risk-adequate manner.

In ESBG's opinion, in order to define comprehensive overall validation outcome, all the validation areas and tests have to be executed, namely for changed as well as for unchanged aspects of the model. Therefore, we are proposing that model changes driven by the ex-ante or ex-post notifications are assessed in the subsequent (annual validation) after the implementation in line with the section 4 for the changed aspects and in line with the section 5 for the unchanged aspects of the model. Moreover, with respect to point c. of the paragraph [26] we would expect further operationalization, as material changes in the range of application of a model might vary in their magnitude.

Actual difficulties can also be encountered in terms of additional data used in the construction of the models in order to execute test out of specification (OOS)/out of trend (OOT) with the more recent data. Moreover, with respect to the use of external data (parr 57), the use of the EBA benchmarking could not be comparable to the information that is already known by the institution due to, for example, different portfolio composition.

Furthermore, as we understand it, para 88 formulates the expectation that the documentation of any notifiable change will be tested by validation before notification. We do not consider this appropriate as this task is not related to the other tasks of validation, especially where non-material changes are concerned. If an independent formal review of notification documents is considered necessary prior to notification, this should be specified in general terms and in any event without assigning the task to the validation function.

**Question 2:** For rating systems that are used and validated across different entities, do you have a particular process in place to share the findings of all relevant validation functions? Do you



**apply a singular set of remedial action across all the entities or are there cases where remedial actions are tailor-made to each level of application?**

Some of our members define 2 types of internal validation findings, namely central and local validation findings. Local findings refer always to the model under investigation and are addressed directly to the model owner and local entity on the solo level, whereas central findings usually refer to e.g. centrally defined methodologies or guidance, and are usually identifying deficiency related to more than one model or to the group-wide models. Both types of the findings are considered in the evaluation of the final validation outcomes with their respective severity.

**Question 3a: Do you deem it preferential to split the review of the definition of default between IRB-related topics and other topics? Please also state the reasons for your answer.**

We believe a generally applicable answer to these questions is not reasonably possible. Whether it makes sense to split the review of the definition of default (DoD) between IRB and non-IRB issues depends on the specific IRB processes in the respective institution, the portfolios affected, and the other processes involved (e.g., accounting, depending on the accounting standard). Therefore, the determination of which role, if any, the validation function should have in the DoD review and which tasks, if any, should be assumed by other organizational units in the respective institution must be made case-by-case basis. Therefore, in our opinion, it should be refrained from making a general specification in this regard.

**Question 3b: If you do prefer a split in question 3a, which topics of the definition of default would you consider to be IRB-related, and hence should be covered by the internal validation function? Please also state the reasons for your answer.**

All the topics having an impact on the performance of the model in terms of risk differentiation and risk quantification, which includes:

- Quality of the DoD simulation, if relevant;
- Representativeness analysis;
- Impact on discriminatory power of the models;
- Impact on back-testing of final estimates;
- Impact of stability of final estimates.

**Question 4: Which approach factoring in the rating philosophy of a model into the back-testing analyses should be considered as best practices? Please also state the reasons for your answer**

Regulation 2022/439 Art. 12 lit. f specifies that the rating philosophy must be considered in backtesting analyses, among other things. Furthermore, the EBA Guidelines (EBA/GL /2017/16) para 66 lit. c in conjunction with para 67, also specify how this should do: the expected responsiveness of PDs concerning changes in macroeconomic conditions based on the respective rating philosophy is examined to determine whether the actual behavior of PDs with default rates over time corresponds to these expectations. In our view, this specification is as specific and concrete as is reasonably possible in a generally usable form.

**The appropriate approach in the validation of the concrete procedure in each case must be specific to the rating philosophy chosen in each case, the characteristics of the respective model, and the underlying segment, and must be designed accordingly** (e.g., taking into account the cyclicity of the segment and the calibration method in the respective model).

**Therefore, in our view, there is no generally applicable "best practice" approach for the specific procedure to consider the rating philosophy in backtesting analyses.** Accordingly, we should refrain from defining or recommending a straightforward "best practice" approach. It would instead make sense



to examine the development of the one-year default rates and mean PDs over time and to define substantial deviations as a reason for further checks concerning the rating philosophy.

An example of the best practice which has been identified by some of our members to factor rating philosophy in the back-testing, would be to assess final probability of default (PD) estimates at any given point in time and at any relevant level against default rate (DR), which is appropriately adjusted to reflect rating philosophy of the model. For this purpose, one needs to operationalize the concept of rating philosophy (through grade assignment dynamic) and the appropriate adjustment.

In case of minimal dynamic of a pure through-the-cycle (TTC) rating system, rating distributions are following the portfolio structure, but are insensitive to economic circumstances. In such a situation the portfolio average PD remains stable, there is no correlation between portfolio average PDs and default rates. In this case, no adjustment to the LRADR is required and portfolio PD back-test is conducted against LRADR at any given point in time.

In case of maximum dynamic of a pure point-in-time (PIT) rating system, rating systems follow the cycle, and default rates per grade are stable (besides random fluctuations) irrespective of the cycle status. In this case, the default rates on the validation sample are the proper targets for back-testing.

As none of these extreme cases can be achieved, hybrid grade assignment dynamics should be characterized by its degree of PITness, specified as a value between 0% and 100%. With such a quantification at hand, the adjusted target for back-testing shall be defined as  $(1 - \text{degree of PITness}) * (\text{LRADR reflecting the long run average}) + (\text{degree of PITness}) * (\text{ODR on validation sample})$ .

**Question 5: What analyses do you consider to be best practice to empirically assess the modelling choices in paragraph [76] and, more generally, the performance of the slotting approach used (i.e. the discriminatory power and homogeneity)? Please also state the reasons for your answer.**

We believe that the best practice approach to empirically assess the modelling choices in paragraph [76] would be:

- Sensitivity analysis by statistical means of migrations driven by the changes in the inputs or aggregation logic at any relevant level;
- Cash-flow back-testing by statistical mean at any relevant level of the model including material sub-ranges of the portfolio – this approach may nevertheless imply higher costs than benefits for the understanding of the model performance.

Moreover, for assessment of the discriminatory power and back-testing purposes, the best practice would be to factorize realized losses by default rate (DR) and loss rate (LR) component over the longer time period and to test it against expected losses (EL) at any relevant level (i.e. model and slot). Discriminatory power can be accessed via monotonicity of the realized losses per SLOT. Homogeneity can be assessed by employing back-testing procedure at any relevant material sub-ranges of the portfolio (i.e. geography, residual maturity, balloon payments, exposure at default (EAD) etc.). It should however be considered that this practice could be not conclusive in relation to the number of defaults that are available.

From a methodological point of view, we believe that the validation procedure for supervisory slotting approaches must also be designed in a risk-adequate manner in line with the proportionality principle. In particular, the materiality of the portfolio must be taken into account by the respective slotting approach.

**Question 6a: Which of the above-mentioned approaches do you consider as best practices to assess the performance of the model in the context of data scarcity? Please also state the reasons for your answer.**

To conduct the validation solely based on either out of trend (OOT) or an out of specification (OOS) sample, using data not used at all by the credit risk control unit (CRCU) for the model development.

**Question 6b: More in general, which validation approaches do you consider as best practices to assess the performance of the model in the context of data scarcity? Please also state the reasons for your answer.**

ESBG would consider following validation approaches as a best practice:

- Aggregation of data from different observation periods or consideration of analyses based on multi-year periods;
- Testing with external benchmarks (e.g. external ratings or market driven metrics such as bond spreads) - this could however be not conclusive in relation to the number of defaults that are available.
- Comparison with internal credit expert ranking (e.g. blind rank ordering tests, whereby the ranking produced by the model is assessed against the ranking produced by credit experts). This process may nevertheless lead a relevant efforts for the institution.

### Additional comments by ESBG:

#### **1. Paragraph 3 (Scope of the validation):**

We would propose to operationalize conditions under which solo level validation outcomes could be inherited from the consolidated level. As this practice has been already approved by ECB in the past (i.e. ECB-SSM-2021-ATERS-6, TRIM-2019-ATERS-3980, obligation #15) we would propose to implement following two conditions under which solo level validation outcomes are inherited from the consolidated level:

- Condition 1: Rating grade assignment process is conducted at consolidated level only (i.e. usually the case when vast majority of the observations and exposure is booked at the holding level)
- Condition 2: There is no sufficient number of observations available at the solo level to conduct meaningful quantitative validation (i.e. quantitative criteria shall be specified by the bank in their validation policy).

#### **2. Paragraph 37 (Assessment of the materiality of a model change or extension, Contex Box 1):**

We would like to point out that calculating the impact of the new model on an already approved model by isolating the non-relevant changes is complex and difficult. In that sense, the most feasible estimation is on the model already implemented at the time of the request for change. We therefore request that in no case should it become a requirement as such and suggest remove this good practice.

#### **3. Paragraph 57 (External data sources):**

Regarding the expectation of using the benchmarks provided by the EBA on the EBA benchmarking portfolios, we would like to mention that differences in the composition of the portfolios can exist between the aggregated benchmark and the Entity's portfolio (to which the first is expected to be compared). In addition, Entities do not have the data to assess to which extent the benchmark is representative of the Entity's portfolio, thus limiting the robustness of the conclusions that can be drawn by this comparison.

#### **4. Paragraph 73 (Assessment of the assignment process for slotting criteria):**



The requirement that “... *the validation function is expected to check that the assignment of exposures to a class of specialised lending exposures is also implemented in a consistent and replicable manner.*” does not seem to be consistent with other portfolios. Based on our understanding, it is not required that IV checks the assignment of retail / corporate / SME exposures to their corresponding regulatory class. We therefore request that in no case should it become a requirement as such and suggest remove this good practice.

#### **5. Paragraph 79 (Validation challengers, Focus Box 5):**

With respect to the Slotting back-testing analysis, which is expected to be generally performed consistent with LGD back-testing mentioned in paragraph [55.c], while considering also non-defaulted exposures using a 0% loss rate, we would like to propose alternative approach as for the suggested one we would see following limitation:

- Up-to-dateness of the outcomes: as workout process for the specialized lending exposures might take longer time period (i.e. on average 5 years or more) the observation period would need to be extended to longer time period in order to have sufficient number of observations (realized LGDs) for the back-testing purposes.

We would like to propose that realized losses are factorized in the default rate (DR) of the performing and loss rate (LR, realized LGD) component of the defaulted portfolio. In this set-up EL can be back-tested at any level against the product of two independent variables DR and LR.

#### **6. Paragraph 105.a (Objectives of the subsequent validation):**

We would propose to take out the following wording “...*check the materiality of model changes that occurred since its last review,..*” as it implies that materiality check or assessment could be done only after the implementation of the model changes.

#### **7. Paragraph 125 (Subsequent validation of the on-balance sheet netting and master netting agreement):**

It seems that the word “previous” is missing before the last word of this paragraph (“assessments”).

#### **8. Paragraph 133, 85.b (Subsequent validation of the implementation):**

We would propose to reduce the frequency of the requirements laid out in the paragraph [85.b] in the course of the subsequent validation to 3 years for the unchanged aspects of the model. In our opinion comprehensive initial (first) validation of the model implementation as well as subsequent validation of the changed model aspects in line with section 4 should be sufficient as comprehensive control mechanism.

#### **9. Paragraph 142 (Non-transferability of the responsibility) & Paragraph 150 (Intragroup outsourcing):**

With respect to the validation responsibility and intragroup outsourcing we would propose to further operationalize conditions in the paragraphs [142] and [150] as it is not clear what are the minimum organizational requirements for the validation function at solo level. In our opinion in case operational tasks of the internal validation function are bundled at the consolidated level in the holding company (i.e. central validation function unit performs operational validation tasks for the whole group) following organizational requirements conditions should be met to satisfy validation responsibility at the solo level:

Paragraphs 121, 122 and 123 of the ECB Guide to internal models (section 8.3.1):



- Supervised entity at solo level has Decision making body (i.e. senior management and the members of the management body or the designated committee thereof) to approve any validation matters (i.e. validation reports, findings, remediation action plans, changes in the validation methodology).

This governance set-up and practice has been accepted by the ECB in several decisions in the past, i.e. ECB-SSM-2019-ATERS-67, ECB-SSM-2020-ATERS-26, ECB-SSM-2020-ATERS-44, ECB-SSM-2021-ATERS-25, ECB-SSM-2021-ATERS-6.





## About ESBG (European Savings and Retail Banking Group)

ESBG represents the locally focused European banking sector, helping savings and retail banks in 21 European countries strengthen their unique approach that focuses on providing service to local communities and boosting SMEs. An advocate for a proportionate approach to banking rules, ESBG unites at EU level some 900 banks, which together employ more than 650,000 people driven to innovate at roughly 50,000 outlets. ESBG members have total assets of €5.3 trillion, provide €1 trillion in corporate loans (including to SMEs), and serve 163 million Europeans seeking retail banking services. ESBG members are committed to further unleash the promise of sustainable, responsible 21st century banking. Our transparency ID is 8765978796-80.



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