**Executive Summary**

**ESBG’s response to the ECB consultation on its revised Guide to Internal Models**

On 15 September 2023, ESBG responded to the European Central Bank (ECB) public consultation on its revised Guide to internal models. The revised Guide clarifies how banks should go about including material climate-related and environmental risks in their models. It also provides clarifications for banks that wish to revert to the standardised approach for calculating their risk-weighted assets. Specifically on credit risk, the guide helps all banks to move towards a common definition of default and a consistent treatment of massive disposals. The update of the market risk chapter details how to measure default risk in trading book positions. The Guide also provides clarifications regarding counterparty credit risk.

Generally speaking, the Guide is very prescriptive in relation to the documentation to be provided in the application for reversion to less sophisticated methods, but it does not explain how the ECB will assess the documentation. More clarity would therefore be needed.

In the event of a model change, we believe it should be sufficient to provide the functional and technical implementation concepts including for systems testing (on the basis of a corresponding simulation environment) as evidence for the ability to provide a new version of the relevant IT systems.

We consider the introduction of a new type of obligor as inconsistent with the currently applicable Article 147 CRR unless the concept of joint credit obligations (JCOs) is fully reflected in internal risk management practices. The added complexity seems redundant from a risk quantification perspective; it would trigger significant investments and it would increase modelling complexity by introducing artificial (highly correlated) clients.

For any adjustments to the definition of default, a quantitative estimate of the impact of the application of the new definition of default is required either in the form of a retrospective simulation, a parallel run or a similar classification of the reference data set. The possibility to qualitatively estimate the impact based on an expert opinion in the case of minor qualitative adjustments should be allowed.

ESBG stressed that in order to increase the representativeness of the loss given default (LGD) development sample to its application scope, it would be better to choose a fixed-time approach where the observations 12 months before default are used. Indeed, the farther away from the default, the more similar will the risk features of the facilities be to the performing application portfolio.
On model-related margin of conservatism (MoC), the requirements regarding internal model validation should not apply at the level of the third-party provider but only at the level of the individual rating model as the resulting interference with the business model and organizational setup of the third-party provider would not be reasonable. Furthermore, applying MoCs at grade or pool level can lead to overestimates, thus it would be useful to find arguments for MoCs to be applied at less conservative levels such as at the calibration segment level.

Due to an inconsistency with CRR, it is then necessary to clarify that the estimate credit conversion factor (CCF) should be computed as “default weighted average resulting from all observed defaults within the data sources”. A minimum CCF of 100% is also not justified since there may be portfolios that are not significant and for which there is not enough information available but in which a CCF of less than 100% can be defended.

Furthermore, treating environmental risks by assigning a ”conservative rating via override” would conflict with the concept of (unbiased) ratings in the methodological sense (e.g. for the purpose of calibration). Overrides generally must not be conservative. In case of application deficiencies in the assignment process acc. to Par. 196 EBA/GL/2017/16, however, conservatism in the application of risk parameters can be applied.

Finally, the implementation of an alternative days past due counter for any country not within the SSM responsibility would be a high effort and it does not justify the minor improvements in credit risk steering. Alternatively, the requirement may be replaced it by a more flexible, potentially conservative, formulation without the need to implement a second days past due counter unconditionally.