



Template for comments

Public consultation on the ECB guide to internal models - General topics chapter

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General comments

The EBF has long supported the continued use of internal models for regulatory purposes for the advantages they offer to better risk management practices in the banking system. We understand that the Targeted Review of Internal Models (TRIM) project is a necessary undertaking to homogenise the methodology of internal models across SSM supervised institutions. Consequently, the EBF broadly supports the TRIM exercise, as it will contribute to restore confidence in banks' regulatory internal models. Also we acknowledge the ECB's will to remain transparent and pragmatic on its supervisory practices which is materialised by the publication of Guides like the one subject to this consultation

GENERAL COMMENTS

The following facts keep the EBF concerned about the direction that the ECB is seeming to take for this Guide

On future work related to internal models (IRB Repair, TRIM outcomes, compliance with ECB Guides), implementation timelines in general remain uncertain as legislative - process or supervisory final decisions are not finalised yet. The ECB Guide refers to several EBA level 2 texts, which are not yet in final version (case of guidelines) or not adopted by the European Commission (case of RTS). Therefore, banks are not expected to be compliant with articles which are not legally binding. The ECB should therefore take into account these uncertainties in its assessment, in particular institutions should not be rushed to comply with these requirements; Principles of separation for 3 lines of defence, i.e. scope of tasks for the Credit Risk Control Unit (CRCU), validation and internal audit

The current version allows a very wide interpretation of these three functions resulting in overlapping tasks. A literal reading of the required tasks could result in a - supervisory expectation of the three lines repeating the same tasks and reporting the same message three times to senior management. We are of the opinion that further clarification is necessary for the minimum scope of the tasks for each of the three defence lines. This aspect should be reviewed for the sake of efficiency

The back-testing of internal models should be allowed to be carried out by the Credit Risk Control Unit (CRCU), ensuring that the internal validation has full autonomy to - lead an independent review with access to golden sources of data

The internal audit has no operational function: the current wording of the guide is misleading, it should be clearer that the internal audit will rely on reports of internal - validation or any "comparable independent auditing unit", which could be the second line of defence in a MRM framework, for the review of internal models, which is compliant with CRR especially Guidelines from EBA on internal governance

Overall, the Future of IRB Approach will encompass the most important parts of model changes in the coming years. From this perspective, the ECB envisages a two-step - approach, which seems to favour a lighter process efficient for both institutions and supervisor. In this spirit, we suggest clarifying and adapting any requirements related to model changes and internal review process in general in the view of applying efficiently these requirements

Regarding the application of governance requirements, the guide sets out a high degree of involvement for the management body which requires very granular oversight and approval for the day-to-day running of model processes. While we support the notion that management bodies should be embedded in the process, it may be more appropriate and pragmatic for the ECB to set a scope which allows for greater delegation of more granular changes

It is important however that the ECB reminds in its guide that the primary objective of the TRIM exercise should be to reduce RWA variability between banks under the current regulatory framework, and not ensuring compliance with possible future rules (for instance the future scope of application of the A-IRB approach) by front running standards which have yet to be transposed to jurisdictional legislation, as for instance Basel III revised framework

In this respect, the ECB should specify that the draft guidelines and RTS not yet adopted by the EU will not apply until they are finalised

ID	Section	Paragraph	Page	Type of comment	Detailed comment	Concise statement as to why your comment should be incorporated
1	Overarching principles for internal models	Regulatory references	4	Clarification	In our opinion the design, the scope and the purpose of the framework need further definition, preferably in consultation with the industry. The requirements can be interpreted in a narrower or in a wider sense, leaving an ample margin for supervisory interpretation which might hamper consistency. For instance, it can be misread to interpret that all models, "not just those used for own funds calculation", are covered by such framework and the enforcement of the framework for not regulatory relevant models would be also questionable.	
2	Overarching principles for internal models	Implementation of a model risk management framework	6	Amendment	Paragraph 14: We welcome the ECB requirements regarding the implementation of a Model Risk Management (MRM) framework, further reflection involving the industry and regulators / supervisors could be undertaken in order to design transparent detailed requirements for such a framework, which ensure consistent implementation within CRR. In particular, the implementation of a MRM framework should not duplicate independent reviews with the same objectives, and it should clarify that the MRM framework, when independence requirements are met, could be part of a Risk Division.	
3	Overarching principles for internal models	Identification of management body and senior management	7	Amendment	Paragraphs 15-18: The guide should appreciate national laws and avoid conflicts in this regard. For instance, under the German law (two tier system), there is already a clear definition of the role of the Supervisory Board and the Management Board, with an ultimate responsibility and liability to manage the company as a whole by the Management Board. We clearly support the requirement to have clear roles and responsibilities of Senior Management to strengthen individual responsibility and clear decision making. However any requirement to have a committee only at board level and/or only chaired by a member of the management body would dilute individual responsibility and accountability. We propose to replace the last sentence with: "The senior management's decision-making procedures relating to all aspects of internal modelling, including its delegation processes, should be clearly documented".	
4	Overarching principles for internal models	General principles for internal validation	8	Clarification	Paragraph 19: In our view, "initial validation" refers to the validation of new models.	
5	Overarching principles for internal models	General principles for internal audit	9	Amendment	Section 2.6 (to be read conjointly with chapter 6): Dealing with section 2.6, we suggest replacing the title "General principles for internal audit" by "General principles for internal audit or another comparable independent auditing unit". In particular, this unit, in compliance with CRR, could be involved in the application of paragraphs 26, 28, 29. The paragraph 27 should be moved in a specific section 2.7 "General principles for internal audit". As the Guide to Internal Models requires institutions to have a model risk management framework (see 2.3), some institutions may want to have a Model Risk Management group in charge of the tasks of the validation function (see section 2.5) in more extensive way as "another comparable independent auditing unit". i.e. the regular review of internal models as described in 2.6 articles 26, 28 and 29. Such a Model Risk Management group is independent from the model development process, as stated for the validation function (which is compliant with section 2.5 article 20 to 23) and complies with article 158 of EBA/GL/2017/11. Consequently, for paragraph 26, we propose the following changes: "The CRR requires internal models to be subject to regular review by the internal audit or another comparable auditing unit, with the strong involvement of a second line of defence in MRM framework if applicable." In addition, we suggest to add at the end of the section 2.6 the following bullet point: "For this purpose, the internal audit shall rely on the work of the internal validation (or second line of defence in MRM framework if applicable), in the sense that the internal validation (or second line of defence in MRM framework if applicable) reviews permanently the models while the internal audit reviews the framework including the aspects related to the Internal Validation function (or second of defence in MRM framework if applicable) and its governance."	
6	Roll-out and permanent partial use	Application of the IRB Approach	11	Clarification	Paragraph 30-33: The Guide highlights an EBA consultation paper 2014/10. The reference is not clear as the RTS is not finalized yet. The Guide should provide transparency how and to which extent the consultation paper has been considered in its current version. We understand that the criteria used to define the application and the sequential implementation of the IRB Approach should be clearly documented and agreed with the competent authorities. This includes also the targeted IRBA coverage. We would appreciate clarification if this would implicitly replace the IRBA coverage ratio thresholds on national level to also support the intended harmonisation of regulations across Europe. Extending IRBA approach is a process which is long and complex, even more if the institution is of a large size. Best practices of risk management may exist even if exposures are not in IRB approach. Therefore, the 5-year timeframe for the initially approved roll-out plan (c.f. paragraph 33) should not be maintained. Instead, the diversification of the risk profile of the institution should be taken into account. We consider each bank should discuss its internal model deployment strategy with its supervisor. In our opinion, it needs to be made clear that JSTs can reach agreement for longer time period when justified. It also should be considered that when portfolios are acquired and rating systems need to be built from scratch, the required data history is longer than the currently expected 5 years. Also, annual monitoring should be inserted in a multiyear perspective as roll-out / PPU plan will hopefully not change drastically each year.	
7	Roll-out and permanent partial use	Governance of the roll-out plan for the IRB Approach	13	Clarification	Paragraph 37: In our opinion, it needs to be clarified what is expected by the last half-sentence "initial/current/planned exposure amounts and risk weighted exposures". Is this requirement only applicable to initial IRB applications? And can RW exposures be calculated on current approaches, or otherwise how future approaches could be simulated if no internal model exist for portfolios in the roll-out plan?	
8	Internal governance	Materiality of rating systems	16	Amendment	Paragraph 44: We are in favour of the notion of materiality of rating systems which makes sense in the monitoring of internal models. However, further work is necessary to clarify the concept and definition of material rating systems. We would strongly support such identification and related maintenance work, if the raised and detailed requirements for IRB rating systems could somewhat be eased for immaterial portfolios. Also, we suggest renaming the concept of "materiality of rating systems" as it creates confusion with "materiality of model changes". Also, we would like clarification on how the ECB will create level-playing field or ensure horizontal harmonisation with diverging materiality assessments between institutions for a same type of portfolio.	
9	Internal governance	Decision-making responsibilities	17	Amendment	Paragraph 49: It is not proportionate to require management board approval for all outsourcing policies. It is understandable in cases when entire functions are outsourced, but not when for example external data is used as model or validation input. Such data is substitutable and the outsourcing only consists of a small element of the rating systems.	
10	Internal governance	Internal reporting	19	Amendment	Paragraph 54: We understand that requesting to report the comparison between estimated PDs and realised default rates on a frequency shorter than one year may impose an excessive burden on institutions. We understand that, for the sake of efficiency, this reporting should be linked to the annual reviews that should be performed on risk parameters. In addition, it must be noted that the Guidelines on PD and LGD estimation were amended in this regard, ceasing to request a mandatory quarterly reporting of realised default rates. Paragraph 55: The Guide stipulates that at least annually, both senior management and the management body should receive an aggregated overview of the validation results for each rating system. For large institutions with high number of rating systems in use these information should allowed to be not provided on rating system level but in an aggregated format.	
11	Internal validation	Validation level	21-22	Clarification	Paragraph 66: It should be clarified that for a rating system which covers several entities of a consolidated Group, the validation should remain at the level of the rating system (no validation at sub-rating-system level).	
12	Internal validation	Content and frequency of tasks of the validation function	22-28	Clarification	Paragraph 69: It should be most welcome to clarify the expectations as regards the benchmarking analysis, especially as regards retail portfolios for which the availability of public information with which to carry out benchmark analysis is scarce. Whereas we agree to the analyses to be performed, some of the stated frequencies for validation are deemed excessive, unduly burdensome, in parts impractical to comply with, and without significant additional value. We are convinced that a risk-based approach requiring action if triggers are hit is a superior approach to revalidation requirements with a fixed frequency. For instance, a monitoring of overrides may trigger a detailed analysis for a rating system (refer to 69. (h) (iv)). Also a prescribed recalibration of model weights on a different than development sample should only be performed in case the model performance deteriorates under a predefined threshold (refer to 69. (h) (iv)). We therefore would appreciate if requirements on depth and frequency of validation activities allow for a risk-based approach. Also, for material rating systems back-testing exercises should be allowed to be made by the first line of defence: - The modelling entities are the expert of the models. This facilitates the recalibration process thus the model lifecycle process; - The back-testing exercises are reviewed by the second line of defence which ensures an independent analysis and challenge against the first line of defence. Paragraph 71: In general we welcome the increased transparency and consistency expected from the proposed threshold requirements outlined in the referenced draft EBA RTS. Meaningful and appropriate measure and thresholds to assess significant deviations in portfolio composition over time still need to be developed and may only become industry standard in several years' time. We thus deem the requirement for measures and threshold for stability of portfolios as pre-mature and propose to defer it to a future version of the RTS.	
13	Internal audit	Scope and frequency of the review of the rating systems	30-32	Amendment	We would like to remind that the mission of internal audit is described in the Internal Audit Function section of the EBA Guidelines 2017/11 on Internal Governance, which states: 199. The Internal Audit Function (IAF) should, following a risk-based approach, independently review and provide evidence of compliance of all activities and units of an institution, including outsourced activities, with the institution's policies and procedures and with external requirements. Each entity within the group should fall within the scope of the IAF. 200. The IAF should not be involved in designing, selecting, establishing and enforcing specific internal control policies, mechanisms and procedures, and risk limits. However, this should not prevent the management of internal controls and compliance with applicable rules. In this respect, the mission of the internal audit is to ensure that the control systems in their design and application are effective and efficient and not to carry out the controls in place of trades. Paragraph 76: For the reasons mentioned in the comments of the section 2.6, we suggest replacing "hereinafter internal audit" by "or the second line of defence in MRM framework if applicable". In particular, in line with EBA GL on internal governance, the internal audit shall rely on the work of the internal validation (or second line of defence in MRM framework if applicable), in the sense that the internal validation (or second line of defence in MRM framework if applicable) reviews permanently the models while the internal audit reviews the framework including the aspects related to the Internal Validation function (or second of defence in MRM framework if applicable) and its governance." Paragraph 80(b): We are in favour of aligning this audit cycle with that of the other risks followed by the internal audit or another comparable independent unit (second line of defence in MRM framework if applicable), which could be different from three years depending on each internal practice. Paragraph 81: This paragraph should clarify that when the internal audit is in charge of carrying the general risk assessment of the framework, as the internal audit has no operational function (in line with EBA Guidelines on internal governance), it shall rely on analysis performed by the Internal Validation function (or second of defence in MRM framework if applicable), except for those aspects related to the Internal Validation function (or second of defence in MRM framework if applicable) and its governance. It is consistent with ECB's principle stated in TRIM General Topics review feedback letters received by some institutions. Paragraph 82: The management body will not go into details of the risk assessment carried out by the audit (or second of defence in MRM framework if applicable) or the different auditing techniques and guidelines, or approve the audit reports. We suggest replacing the wording with this one: "the results of the general risk assessment and prioritization, the annual audit plan or work plan by the second line of defence in MRM framework are communicated to the management body and the risk committee". Paragraph 83: We suggest the following wording "it is beneficial if the internal audit (or second of defence in MRM framework)..." Paragraph 84: This paragraph is not sufficiently clear. We would like to have confirmation that if a material change is reviewed by internal validation (or second line of defence in MRM framework) we do not necessarily need another review. Therefore, in line with what we have mentioned in our comments on paragraph 26, we suggest modifying the wording like this: "For extensions and changes to the IRB approach, institutions shall submit, among other things, reports of the validation function or any comparable independent auditing unit. These aspects should also be considered in the context of an independent assessment by the internal audit function".	

14	Model use	Assignment of exposures to grades or pools	38-41	Clarification	<p>Paragraph 93 (b): It is not clear why 'and/or' is in the last half-sentence for 'reviewed by the internal validation function and/or internal audit'. An 'or' relationship should be enough. This example also relates to the comment about overlapping validation/ internal audit tasks.</p> <p>Paragraph 95: We understand that applying the worst performing rating grade for unrated exposures may be excessively conservative. We suggest applying alternative measures, for instance based on downgrades with respect to average ratings, along with strict controls on the reasons behind the existence of unrated exposures.</p> <p>Paragraph 95a: The first aspect that should be clarified by ECB is if a certain (marginal) share of UR, within an AIRB perimeter, is allowed or if the UR should tend to zero by definition (both in terms of numbers and in terms of exposure / EAD/ RWA); the current share of UR could be related to the model design - currently validated and in use by the Institutions - (e.g. balance sheet not available for the newco, foreign counterparties, etc.) or for specific characteristics of a given counterparty within an AIRB portfolio (e.g. Institutions). Considering the previous general observation, we deem appropriate the proposed approach allowing for a prudential treatment for outdated rating (e.g. time-dependent downgrading for outdated rating).</p> <p>On the contrary, some doubts are related to the proposed process for the UR counterparties. The prudential treatments ("...the attribution of the worst performing rating grade") can be considered appropriate if it is related to the share of "unjustified UR" (e.g. situations where a counterparty is UR, but all the implemented conditions – validated by the competent authority within the model framework – for the rating attribution are fully verified). In this scenario, it is reasonable to apply the described prudential approach until the rating will be attributed.</p> <p>Instead, when the unrated is justified (within the validated model framework) the proposed prudential approach should be reviewed considering also the methodological approach used for the Long Run Average Default Rate (LRADR) calculation.</p> <p>For example, when the LRADR (used for PD calibration purposes) is computed including the subset of unrated counterparties in the historical reference perimeter, it should be considered that this usually lead to an implicit penalization (a higher overall LRADR) for the sub-sample of rated counterparties (e.g. the SME Corporate UR have usually a higher default rate with respect to the one observed for the rated counterparties). In this case, the use of specific "PD benchmark" should be allowed (e.g. two LRADR should be calculated: one for the rated and one for the attribution of a benchmark PD for the UR sub-sample).</p> <p>In general term, the following aspects should be evaluated in defining the logic for managing UR counterparties:</p> <p>I. Methodological aspects (e.g. model review), which could be relevant and hence subject to specific approval by ECB (e.g. new model change application);</p> <p>II. New PPU applications in order to define a precise sub-perimeter (within each AIRB portfolio) where the standard treatment is allowed (e.g. specific cluster of counterparties, currently UR, should be moved in a new PPU sub-segments). Moreover, ECB should apply a greater level of flexibility in evaluating the (new) PPU requests for specific sub-samples of counterparties / types of exposure, considering that, within some portfolio (e.g. Institutions), several counterparties' features (e.g. type of business, economic/financial structure, complexity of the organization, etc.) make the rating attribution objectively difficult;</p> <p>III. Impacts on the Institutions' internal process (e.g. process, pricing, etc.) and on their organizational structure; IV. IT impact;</p> <p>VECB's related effort (e.g. ex-ante / ex-post notifications, new model change application, PPU application...).</p> <p>Moreover, an appropriate period of time and a progressive approach (eventually based on materiality of the portfolio/model) should be allowed for the Institutions to be fully compliant with the ECB's requirement.</p> <p>Paragraph 97: This paragraph implies that each deviation from any internal policies needs to be analysed by CRCU and validation function. In our view, this requirement is disproportionate and does not seem to be well justified or purposeful. We would suggest revising it. Also, it would be welcome to clarify the notion of 'deviations from internal policies and/or procedures'.</p>
15	Management of changes to the IRB approach	Classification	44	Clarification	<p>Paragraph 109: To ensure the accuracy of the impact assessment and the correctness and consistency of the resulting classification, the institution is expected to establish a four-eye-principle. This means that the assessment and classification are confirmed by an independent unit. We would appreciate clarification which of the arrangements mentioned in paragraph 20 are possible.</p>
16	Management of changes to the IRB approach	Impact assessment	45	Amendment	<p>Paragraph 112(a): Nine months is considered as a minimum timeframe after reference date as the sum of the following periods:</p> <ul style="list-style-type: none"> - The modelling unit makes an assessment (2-3 months); - The validation function reviews the assessment (3 months / 4-5 months if changes are material); - The modelling unit takes into account any modification (1-2 months); - Documentation and notification process (1 month). <p>We suggest amending paragraph 112(a) and introducing a tolerance time period.</p> <p>Paragraph 112 (c): It is not clear why a behavioural scoring is an example for scoring where human judgement of qualitative variables is needed.</p>
17	Management of changes to the IRB approach	Re-rating process	47	Clarification	<p>Paragraph 121: It is not clear why a linear reduction of simulated RW exposures would be the best practice and how such treatment can be justified in light of recent data quality requirements for RW exposure amount calculations.</p> <p>Paragraph 121 (b): We would like to warn the supervisor of the complexity induced by the application of this paragraph, though in some sense understandable from a supervisory standpoint. It will require a high level of new development in terms of calculation tools, considered as unduly burdensome. Also, we note that the reference "more than 10% on the range of application of the rating system subject to change" is contradictory with the notion of materiality in regulation 529/2014 and potentially the notion of materiality of rating systems.</p> <p>The guide should provide details on how the additional RWA exposure should be considered in the capital calculation. That means, what is meant with "apply the simulated RWA exposure amount impact". Furthermore, the reduction should be in line with the progress made in terms of re-rating to avoid double counting.</p>
18	Third party involvement	Preliminary principles	48	Deletion	<p>Requirements are the same for internal outsourcing within a group as for external outsourcing. These requirements endanger centrally developed rating models. We suggest eliminating the requirements if the group members are located within SSM and ease the requirements if group members are located in the EU but outside of SSM. Stricter requirements should generally be applied for external outsourcing than for internal.</p>