EUROPEAN CENTRAL BANK

BANKING SUPERVISION

Template for comments

Public consultation on the revised ECB guide to internal models

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General comments

Template for comments

Public consultation on the revised ECB guide to internal models

Please enter all your feedback in this list.
When entering feedback, please make sure that:
- each comment deals with a single issue only;
- you indicate the relevant chapter/section/paragraph, where appropriate
- you indicate whether your comment is a proposed amendment, clarification or deletion.

Deadline: 15 September 2023

ID	Chapter	Section	Paragraph	Page	Type of comment	Detailed comment	Concise statement as to why your comment should be incorporated	Name of commenter	Institution	Personal data
1	Credit risk	8 Model-related MoC	210	141	Clarification	**Question:** Is the default dependency between obligors a driver of the MoC C and, if so, are financial institutions allowed to estimate these default dependencies themselves (as, for example, in pillar II) rather than relying on the regulatory asset correlations defined in Article 153 1 (iii) and Article 154 1 (ii) of the CRR? **Background:** On the one hand, this paragraph stipulates that the MoC C should be based on the distribution of the long run average default rate (LRADR). Based on central limit theorems, we may assume that the LRADR approximately follows a normal distribution. The normal distribution is fully characterized by its mean and variance. For example, we can estimate the variance of the LRADR through its sample variance (i.e. through the variability of default rates across time) of which the correlation can be a main driver. On the other hand, this paragraph does not explicitly mention default dependencies as drivers of the MoC C.	Clarification of this comment will reduce the unjustified variability in estimates of risk parameters stemming from different modelling practices and interpretations of fundamental concepts across banks applying the internal rating based approach.	Wosnitza, Jan Henrik	University of Applied Sciences Stralsund	Publish
2	Credit risk	8 Model-related MoC	210	141	Clarification	**Question:** As explained in the comment above, "the variability of default rates across time" can be a central element of the distribution of the long run average default rate. In contrast, it was clarified under reference number 3 in Subsection 3.7 of the 'Feedback statement: Responses to the public consultation on the draft ECB guide to internal models - risk-type-specific chapters' that "it was not the ECB's expectation that institutions use the variability of default rates across time as the main input for the MoC calculation". Could you please explain how these two statements (i.e. (i) the MoC C should be based on the distribution of the long run average default rate (LRADR) and (ii) it was not the ECB's expectation that institutions use the variability of default rates across time as the main input for the MoC calculation) fit together?	The clarification of this potential contradiction will avoid future misunderstandings between on-site inspectors and banks.	Wosnitza, Jan Henrik	University of Applied Sciences Stralsund	Publish
3	Credit risk	8 Model-related MoC	210	141	Amendment	**Question:** It seems to be a common practice to choose a more conservative percentile of the PD estimate in order to arrive at a PD estimate including a MoC C. Which confidence level does the ECB consider adequate for standard retail portfolios at grade level and at calibration segment level?	Providing this piece of information will reduce the unjustified variability in estimates of risk parameters stemming from different modelling practices and interpretations of fundamental concepts across banks applying the internal rating based approach.	Wosnitza, Jan Henrik	University of Applied Sciences Stralsund	Publish

4	Credit risk	8 Model-related MoC	210	141	Clarification	**Question:** Does the this paragraph express a preference towards MoC C quantification at grade level rather than at calibration segment level and, if so, why does this paragraph prefer MoC C quantification at grade level, although such a MoC C easily can destroy the monotonicity of PD estimates? Furthermore, both MoC C quantification at grade level and at calibration segment level can result in the same level of MoC C by adjusting the level of confidence (see above comment), respectively. **Background:** In our opinion, the MoC C quantification at grade level suffers from the following two main drawbacks. First, applying higher MoC C at good grades than at medium grades might destroy the monotonicity of the default rates per grade. There are at least two reasons why the MoC C of good rating classes can be higher than the MoC C of medium rating classes. For one thing, the ECB expects "that the lower the number of observations per grade […], the higher the MoC of the grade should be". Since good (and bad) rating classes are usually less populated than medium rating classes, the quantification of the MoC C for good (and bad) rating classes rests on less observations and, thus, can be higher than for the well populated medium rating grades. For another, the default correlation is usually higher in better rating grades (see, for example, Article 153 (1) (iii) and Article 154 (1) (ii) of the CRR) and the higher default correlation transpires into a higher variance of the average default rates. Second, MoC C quantification at grade level assumes that the observed default rate is higher than the LRADR for each and every grade. Using these conservative default rates per grade leads to a level of conservatism at calibration segment level that is higher than the confidence level applied at grade level, and the difference between the two increases with the number of grades. Hence, the number of rating classes becomes a driver of MoC C at calibration segment level, but is not explicitly mentioned in this paragraph. Furthermore, adjusting the confidence level at calibration segment level can always result in a MoC C that complies with a regulatory defined target level at grade level.	Clarification of this comment will increase the acceptance of this regulatory document.	Wosnitza, Jan Henrik	University of Applied Sciences Stralsund	Publish
5	Credit risk	8 Model-related MoC	210	141	Clarification	**Question:** This paragraph explicitly requires that "institutions need to be aware of and deal adequately with the dependency between default rates over time on the quantification of the MoC, e.g. when using overlapping windows for the calculation of default rates". MoC C quantification approaches for non-direct PD estimates often assume (i) independent and (ii) identically distributed default rates across time. Why does this paragraph not challenge the assumption of identically distributed default rates?	Clarification of this comment will reduce the unjustified variability in estimates of risk parameters stemming from different modelling practices and interpretations of fundamental concepts across banks applying the internal rating based approach.	Wosnitza, Jan Henrik	University of Applied Sciences Stralsund	Publish
6	Credit risk	8 Model-related MoC	210	141	Clarification	**Question:** Does this paragraph require to consider the risk differentiation function as an additional source of uncertainty for MoC C quantification when using direct PD estimates and, if so, what is the reason for this unequal treatment? **Background:** On the one hand, the MoC C should be based on the distribution of the LRADR when using non-direct PD estimates. On the other hand "the MoC is based on the distribution of this direct PD estimator (which includes the risk differentiation function)" when using direct PD estimates. According to https://doi.org/10.21314/JCR.2022.005 (and references therein), we can think of a PD estimate as a product of two factors. Currently, we are under the impression that the MoC C for non-direct PD estimates should only cover the uncertainty of the first factor, while the MoC C for direct PD estimates should cover both factors.	Clarification of this comment will reduce the unjustified variability in estimates of risk parameters stemming from different modelling practices and interpretations of fundamental concepts across banks applying the internal rating based approach.	Wosnitza, Jan Henrik	University of Applied Sciences Stralsund	Publish