



Template for comments

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

Institution/Company

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General comments

The French Banking Federation welcomes the opportunity to share its comment with the ECB on its draft guide relative to the Targeted Review of Internal Models – TRIM, which will be conducted up to 2019

The FBF broadly supports this 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 their supervisory practices which is materialised by the publication of such guides

: As a matter of fact the FBF is concerned about the direction, that the ECB is seeming to take for its TRIM exercise

On future work related to internal models (IRB Repair, TRIM outcomes, compliance with ECB Guides), implementation timelines in /1 general remain uncertain as legislative process or supervisory final decisions are not finalized 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 bindingThe ECB should therefore take into account these uncertainties in its assessment, in particular institutions should not be "rushed" to comply with these requirements

The roles and responsibilities of the lines of defense which must ensure the independency of functions in line with other regulatory /2 : framework

- i) The backstesting of internal models should be realized by the CRCU, ensuring that the internal validation has full autonomy to lead an independent review with access to golden sources of data
- ii) 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 defense in a Model Risk Management (MRM) framework, for the review of internal models, which is compliant with CRR especially Guidelines from EBA on internal governance
- iii) Overallly, 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 to clarify and adapt any requirements related to model changes and internal review process in general in the view of applying efficiently these requirements

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 non voted rules, as for instance Basel III revised framework

.In this respect, the ECB should specify that the draft guidelines and non voted RTS 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	Documentation of internal models	6	Clarification	We welcome the ECB requirements regarding the implementation of a 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 interdependency requirements are met, could be part of a Risk Division.	
2	Overarching principles for internal models	Identification of management body and senior management	7	Amendment	Paragraph 18: 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.	
3	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.	
4	Overarching principles for internal models	General principles for internal audit	9-10	Amendment	To be read conjointly with chapter 6 Dealing with section 2.6, we suggest to replace the title "General principles for internal audit" by "General principles for internal audit (and second line of defence in MRM framework if applicable)". 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 section specific in a 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 instance, 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 line of defence in MRM framework if applicable) and its governance."	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.
5	Roll-out and permanent partial use	Application of the IRB Approach	12	Amendment	Paragraph 33 : "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 years timeframe for the initially approved roll-out plan (cf paragraph 33) should not be maintained but rather take into account the diversification of the risk profile of the institution. We consider each bank should discuss its internal models deployment strategy with its supervisor. Also annual monitoring should be inserted in a multiyear perspective as roll-out / PPU plan will hopefully not change drastically each year.	
6	Internal governance	Materiality of rating systems	16	Amendment	Paragraph 44: We suggest to rename the concept of "materiality of rating systems" as it creates confusion with "materiality of model changes". Also, we would like better clarification on how the ECB will create level-playing field or ensure horizontal harmonization with diverging materiality assessments between institutions for a same type of portfolio.	We are in favour of the notion of materiality of rating systems which makes sense in the monitoring of internal models.
7	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)	
8	Internal validation	Content and frequency of tasks of the validation function	23-28	Clarification	Paragraph 69(h) In all cases, backtesting exercises should be made by the first line of defense : - The modelling entities are the expert of the models. This facilitates the recalibration process thus the model lifecycle process ; - The backtesting exercises are reviewed by the second line of defense which ensures an independent analysis and challenge against the first line of defense.	
9	Internal audit	Scope and frequency of the review of the rating systems	30-32	Clarification	To be read conjointly with section 2.6	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 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.

10	Internal audit	Scope and frequency of the review of the rating systems	30	Amendment	To be read conjointly with section 2.6 For the reasons mentioned in the comments of the section 2.6, we suggest to replace "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."	To be read conjointly with section 2.6
11	Internal audit	Scope and frequency of the review of the rating systems	30-31	Amendment	Paragraph 80(b) We are in favor 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.	To be read conjointly with section 2.6 (comment Id 04) and comment #9
12	Internal audit	Scope and frequency of the review of the rating systems	31	Amendment	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.	
13	Internal audit	Scope and frequency of the review of the rating systems	31	Amendment	Paragraph 82 We suggest to replace the wording : "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".	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
14	Internal audit	Scope and frequency of the review of the rating systems	31	Amendment	Paragraph 83 : We suggest to replace the wording into: "To avoid delays in the procedures related to an initial IRB application or an application to extend the IRB Approach to an exposure class or a type of exposure that is currently treated using the Standardised Approach, it is beneficial if the internal audit or another comparable independent reviewing unit such as the second line of defence in MRM framework provides the competent authority with an independent assessment of the compliance of the initial IRB application or extension package with all applicable requirements. This applies in particular to compliance with the experience test requirements of Article 145 of the CRR. The benefit of carrying out an internal review of this nature is that shortcomings can be addressed by the institution before submitting the application, and the completeness of the initial IRB application or extension package can be ensured."	To be read conjointly with section 2.6 (comment Id 04) and comment #9 : 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 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.
15	Internal audit	Scope and frequency of the review of the rating systems	32	Clarification	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 don't necessarily need another review. Therefore, in line with what we have mentioned in our comments on paragraph 26, we suggest to modify the wording : "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."	
16	Management of changes to the IRB approach	Impact assessment	45	Amendment	We suggest amending paragraph 112(a) and introducing a tolerance time.	Paragraph 112 (a) : Nine months is considered as a minimum timeframe after reference date as the sum of the following periods : - 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).
17	Management of changes to the IRB approach	Re-rating process	47	Deletion	The following reference (paragraph 121 (b)) should be deleted : "more than 10% on the range of application of the rating system subject to change"	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.