

## **Validation reporting on internal models for credit risk – Letter to significant institutions**

For the attention of the Board,

This letter is to inform you about the launch of the annual validation reporting on internal models used for calculating own funds requirements for credit risk.

### **Background**

Significant institutions' internal validation plays a key role in the European Central Bank's (ECB) assessment of the reliability and accuracy of their internal models. At the same time, it serves as an important input to the ECB's assessment of the quality and regulatory compliance of internal models.

As part of its ongoing review of the regulatory compliance of the internal ratings based (IRB) approach, the ECB requires significant institutions that have permission to use the IRB approach (hereinafter simply "institutions") to calculate their own funds requirements for credit risk to provide information on their probability of default, loss given default (LGD)<sup>1</sup>, credit conversion factor models and the slotting approach they apply to specialised lending exposures.

### **Why does the ECB require this information?**

The ECB requires this information in order to be able to assess:

- i) whether the models under the IRB approach effectively capture the credit risks to which the institutions are exposed so they can adequately calculate their own funds requirements for credit risk;
- ii) whether the institutions have robust systems in place to validate the accuracy and consistency of rating systems, processes and the estimation of all relevant risk parameters, in line with Article 185 of Regulation (EU) No 575/2013<sup>2</sup>.

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<sup>1</sup> Including LGD models for defaulted assets and expected loss best estimate.

<sup>2</sup> Regulation (EU) No 575/2013 of the European Parliament and of the Council of 26 June 2013 on prudential requirements for credit institutions and investment firms and amending Regulation (EU) No 648/2012 (OJ L 176, 27.6.2013, p. 1).

To satisfy these information requirements, the ECB is launching the annual “validation reporting on internal models for credit risk”, as explained in the instructions<sup>3</sup>.

### **What will the information be used for?**

The information from the validation reporting on internal models for credit risk will play an important role in the ECB’s future supervision of institutions’ internal models. In particular, it will enable the ECB to:

- i) enhance the prioritisation of on-site and off-site model reviews;
- ii) monitor the completeness of validation reports prepared according to the annual validation cycle;
- iii) monitor and challenge the results of the internal validation reports over time using transparent statistical measures and tests.

### **How will the validation reporting affect institutions?**

The data collection process for the validation reporting has been carefully designed to minimise the burden on institutions. It will involve simple statistical measures and tests that are similar to those already used by institutions. However, it will not replace the institutions’ own internal validation processes; it will merely establish a common minimum base of statistical tests to be conducted on a standardised set of validation samples that are then reported to the ECB. Institutions are also expected to benefit from the enhanced level playing field created by harmonised reporting.

### **Scope of data collection**

Data will be collected on all internal models for which the institutions have or will receive permission to calculate own funds requirements for credit risk at the highest level of consolidation within Member States participating in the Single Supervisory Mechanism. Institutions that are already using internal models will receive individual ECB supervisory decisions requesting the information, including the date when the reporting will become mandatory for them. Institutions that receive permission to use internal models in the future will receive their decision letters in due course.

The ECB will launch a frequently asked questions (FAQ) process in order to clarify technical questions.

Yours sincerely,

*[signed]*

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*[signed]*

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<sup>3</sup> The [instructions](#) are published on the [ECB Banking Supervision website](#), together with the corresponding [templates](#) for institutions to complete.