
AFME comments on the ECB's draft TRIM guide to internal models – General topics chapter

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The Association for Financial Markets in Europe (AFME) would like to share some overarching and technical comments on the **ECB's consultation launched March 28th 2018 on the TRIM guide to internal models – General topics chapter** reflecting the views of our membership.

Overview

Since the TRIM guide was published in February 2017, industry has provided feedback via the ECB's initial consultation. The publication of the first chapter to the final guide (which is an update to the 2017 TRIM guide) marks a welcome reflection on industry's request for a general topics chapter setting out overarching principles in terms of how the ECB will assess internal models. We also welcome the intention of the ECB to be a transparent player in terms of how it expects internal models to be governed and consider it good practice that the ECB is basing their work on the on-site missions they are undertaking with firms.

Nonetheless, we have some general concerns regarding the direction of the guide, namely:

- Uncertainty around implementation timelines of final supervisory decisions given the references to EBA level 2 texts which are not yet finalised. We would urge the ECB not to unduly push institutions to be compliant with standards which are not yet final and could be subject to further changes. Moreover, the aim of the TRIM exercise is for the ECB to address RWA variability between banks under the current regulatory framework. In this respect the guide should not seek to pre-empt future rules that have not yet been agreed by legislators.
- 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.
- The differentiation between the roles and responsibilities of the lines of defence – these should ensure the independence of the different functions in line with the regulatory framework. In particular:
 - The CRCU should be responsible for back-testing of internal models to ensure the internal validation has the full autonomy to lead an independent review on sound data.
 - The internal audit unit has no operational function. The current drafting on this is unclear. It should be made explicit that the internal audit relies on the reports of internal validation or any “comparable independent auditing unit” (which could be the second line of defense in a Model Risk Management framework) for the review of internal models, which is compliant with CRR, and more specifically EBA Guidelines on internal governance.

- The Future of the AIRB 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 and more efficient process for institutions and supervisors alike. In this spirit, we suggest clarifying and adapting requirements related to model changes and internal review processes with a view to efficient application.

We also consider there are a number of specific areas which the ECB will need to consider in greater detail before finalising the guide, including: materiality of ratings systems; practical application of governance requirements; the roll out of the PPU and the time frame for doing so. Our views on these issues are set out in further detail below.

Overarching principles for internal models

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 would ensure consistent implementation within CRR. In particular, the implementation of an MRM framework should not duplicate independent reviews with the same objectives, and it should clarify that the MRM framework could be part of a Risk Function when ‘independency’ requirements are met.

Paragraph 18:

We propose replacing the last sentence as follows: *“The senior management’s decision-making procedures relating to all aspects of internal modelling, **including its delegation processes**, should be clearly documented.”*

Paragraph 19:

We note in para 19 that the initial validation is also required in the instance of material changes. In our view, “initial validation” refers to the validation of new models only. Indeed, for further clarification, it would be useful if ECB could confirm whether it expects the same validation standards for ‘initial validation’ of new models and for material model changes and extensions. Section 2.6 (to be read conjointly with chapter 6):

Regarding section 2.6, we suggest replacing the title “General principles for internal audit” with “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 change:

“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 defense in MRM framework if applicable.”

In addition, we suggest adding the following bullet point to the end of the section 2.6:

“For this purpose, the internal audit shall rely on the work and process of the internal validation (or second line of defense in MRM framework if applicable), in the sense that the internal validation (or second line of defense 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 defense in MRM framework if applicable) and its governance.”

Roll out of the PPU (paragraph 33)

We consider that the time frame to comply with the initially approved roll out plan within 5 years could be unrealistic for firms to meet. Extending IRBA approach is a long and complex process, even more so if the institution is large. Best practices of risk management may exist even if exposures are not under the IRB approach. Therefore, the ECB should take into account the diversification of the risk profile of the institution and discuss on a bank by bank basis their internal models deployment strategy the rather than setting a fixed timeframe.

In addition, annual monitoring should be inserted in a multiyear perspective as it is not expected to make major changes year on year to the roll-out / PPU plan.

On the issue of coverage, the general understanding is that the development of a roll out plan should be on supervised-entity basis. However, the ECB should give consideration to large multinational institutions where the overall IRB rollout plans are implemented and monitored on a consolidated basis at a group level.

The ECB should also take the interaction between the PPU with the forthcoming Basel III December 7 agreement into consideration.

Materiality of ratings systems (paragraph 44)

While we support the notion of materiality of rating systems it could run the risk of being confused with the concept of materiality of model changes. The ECB should also consider the level playing field aspect, where there are potentially divergent materiality assessments for institutions with the same type of portfolios. Given the different size and complexity of the institutions, the ECB should allow individual institutions the ability to define the materiality threshold of its rating systems within its own model risk management framework and according to the size and complexity of the institutions.

Internal Reporting

Paragraph 54

We consider 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. On the basis of efficiency this reporting should be linked to the annual reviews that should be performed on risk

parameters. In addition, it should 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.

Internal Governance

Paragraph 63

We would welcome clarification on what additional activities are expected in the 'Annual review of estimates' described, and how they may differ or be in addition to the activities undertaken by the CRCU and Validation Function as mentioned in paragraph 63.

Internal validation

Some aspects of the approach proposed by the ECB could be incompatible with organisations' current practices and internal organisational set-up, hence we suggest renaming it. In particular, it does not reflect on the separation between the different lines of defence, namely between the roles of the CRCUs and internal validation. We would welcome clearer delineation between the two functions and a clearer definition of CRCU within this context.

Paragraph 69(h):

In all cases, back-testing exercises should be done by the first line of defense:

- The modelling entities are the experts of models. This facilitates the recalibration process, thus the model lifecycle process;
- The back-testing exercises are reviewed by the second line of defense which ensures an independent analysis and challenge against the first line of defense.

We would also welcome clarification of 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.

The role of internal audit

We would like to emphasize that the role of internal audit is set out in the Internal Audit Function (AIF) 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 role of internal audit is to ensure that the control systems are effective and efficient in their design and application, not to carry out the controls in place of the comparable independent unit (cf. para 26).

Paragraph 78

For the reasons mentioned in the comments of the section 2.6, we suggest replacing “*hereinafter internal audit*” with “*or the second line of defense 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 defense in MRM framework if applicable), where the internal validation (or second line of defense 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 defense in MRM framework if applicable) and its governance*”.

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 defense 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 defense in MRM framework if applicable), except for those aspects related to the Internal Validation function (or second of defense in MRM framework if applicable) and its governance. This 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 defense in MRM framework if applicable) or the different auditing techniques and guidelines, or approve the audit reports. We therefore suggest changing the wording as follows: “*the results of the general risk assessment and prioritization, the annual audit plan or work plan by the second line of defense in MRM framework are communicated to the management body and the risk committee*”.

Paragraph 83:

With respect to this paragraph it should be noted that the role of internal audit is to ensure that the control systems—including those around regulatory compliance—are effective and efficient in their design and application, not to carry out the controls in place of the comparable independent review.

An internal audit review of every IRB application or extension package prior to its submission to the ECB should not be a hard requirement, but rather will continue to be considered at the discretion of internal audit on a model-by-model basis as part of its current risk-based coverage approach.

We also suggest the adding following wording “it is beneficial if the internal audit (*or second line of defense 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 defense in MRM framework) we

don't necessarily need another review. Therefore, in line with our comments on paragraph 26, we suggest the following: *"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."*

Assignment of exposures to grades or pools

Paragraph 95

We consider 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 exposure.

Model changes

We would welcome more clarity on the notion of 'deviations from internal policies and/or procedures' under paragraph 97.

Paragraph 106

We would welcome a central repository of these model change notification templates to ensure consistency, appropriate governance/change-control and to facilitate understanding of the requirements at early stages of model development or change.

Furthermore, the TRIM guide requires that change requests for each model change are confirmed under the 'four-eye principle' (para 109). Some institutions' changes may run into the hundreds, if not over a thousand on an annual basis. It is therefore unclear how this shall be practically applied.

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).

We suggest amending paragraph 112(a) and introducing a tolerance time.

Paragraph 121 (b):

We suggest deleting the reference *"more than 10% on the range of application of the rating system subject to change"* as it is contradictory with the notion of materiality in regulation 529/2014 and potentially the notion of materiality of rating systems.

Third-party involvement (section 9)

It is important that ECB considers further flexibility and provides additional guidelines on internal risk outsourcing. It is our view that the outsourcing risk between group functions and subsidiary/regional entities is different from the risk associated with true external 3rd parties. This is a material consideration for large multinational institutions as certain functions are outsourced to centralised units for reasons of independence and operational efficiencies. This would be overly burdensome should there be an implied requirement to replicate at the different legal/regional entity level.

Application date

It is not clear from which date this guidance will be binding and deployed in inspections. We also note the IRB repair programme is not finished yet. The SSM should therefore await for the legal process related to the IRB repair to be completed before banks are expected to fully comply.

Conclusion

We look forward to continuing to work with the ECB on this 2-3 year project to set proportionate and effective supervisory expectations for institutions' models in an open and constructive manner.

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AFME represents a broad array of European and global participants in the wholesale financial markets. Its members comprise pan-EU and global banks as well as key regional banks, brokers, law firms, investors and other financial market participants. We advocate stable, competitive, sustainable European financial markets that support economic growth and benefit society. AFME is the European member of the Global Financial Markets Association (GFMA) a global alliance with the Securities Industry and Financial Markets Association (SIFMA) in the US, and the Asia Securities Industry and Financial Markets Association (ASIFMA) in Asia. AFME is listed on the EU Register of Interest Representatives, registration number 65110063986-76.