FINANSTILSYNET

MEMO

DANISH FINANCIAL SUPERVISORY AUTHORITY

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Banking Division 1
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Validation of changes to the IRB Approach prior to implementation

According to Article 185 in the CRR-regulation[1] IRB institutions must introduce robust systems to validate the accuracy and consistency of rating systems, procedures, and estimation of all relevant risk parameters.

Furthermore, it follows from Article 143 in CRR that institutions must obtain prior permission of the competent authorities for material changes to a rating system and material changes to the range of application of a rating system. The conditions for these material changes are specified in a technical standard[2].

Article 8 in the technical standard specifies the requirements for documentation in relation to applications for material changes. It follows that applications must include "reports of the institutions' independent review or validation".

The Danish FSA would like to emphasize that the FSA in general expects the institutions to perform a validation of changes in rating systems before implementation. This applies regardless of whether the changes must be approved by the FSA or not. With regard to the changes that must be approved, the FSA expects a validation report in relation to applications of material changes.

Hence, it is the FSA's experience that validation of changes before implementation is an essential element in relation to ensure robust rating systems

[1] 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.
[2] COMMISSION DELEGATED REGULATION (EU) No 529/2014 of 12 March 2014 supplementing Regulation (EU) No 575/2013 of the European Parliament and of the Council with regard to regulatory technical standards for assessing the materiality of extensions and changes of the Internal Ratings Based Approach and the Advanced Measurement Approach.

and to avoid model changes soon after implementation. The validation should, as a starting point, be equivalent to a regular validation, which will be performed after implementation of the changes.

The validation must not necessarily wait until out-of-time data becomes available. The validation may be performed using simulation techniques. For instance, this would allow the institution for validation purposes to make estimations based on a subset of data and then test the results against the remaining data. In all circumstances, validation must be based on meaningful data.

Regardless of the abovementioned, FSA acknowledge that there exists a minimum threshold, where model validation before implementation is not necessary. However, the FSA is not able to define this threshold in advance. In general, the FSA does not expect a validation when debugging or re-estimating an existing model, where the model parameters do not change significantly.