



Public consultation on the ECB guide to internal models – risk-type-specific chapters

Frequently asked questions

What is the purpose of the ECB guide to internal models?

The ECB guide to internal models will help achieve a major objective of ECB Banking Supervision: ensuring that high supervisory standards are applied consistently for directly supervised institutions and that the rules regarding the use of internal models, laid down in the Capital Requirements Regulation (CRR - 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), are understood in a consistent manner. The guide provides transparency on how the ECB understands the most significant aspects of the applicable regulations governing the internal models used by the institutions it directly supervises to compute own funds requirements for credit, market and counterparty credit risk.

What is the purpose of the three risk-type-specific chapters of the ECB guide to internal models?

The three risk-type-specific chapters of the ECB guide to internal models (i.e. the chapters on credit risk, market risk and counterparty credit risk) are intended to inform institutions in a transparent way about the ECB's understanding of various aspects of the applicable regulations for each specific risk type.

The content of each chapter of the ECB guide is based on the requirements of the CRR. Each chapter expresses how the regulatory provisions of relevance to the topic in question are understood by the ECB when it reviews the internal models used by institutions to calculate their own funds requirements. In this regard, the ECB takes the specificities of each bank into consideration when applying the relevant framework.

It is important to underline that the ECB guide to internal models does not aim to cover exhaustively all the topics related to the CRR requirements on the use of internal models for regulatory purposes. The areas covered in the different chapters are based on the initial topics selected for the targeted review of internal models (TRIM) project.

The credit risk chapter covers selected topics regarding the internal ratings-based approach for calculating own funds requirements, including an initial section covering data maintenance for this approach followed by specific modelling aspects relating to estimation of probability of default (PD), loss given default (LGD) and conversion factor (CCF).

Regarding the market risk chapter, the selected topics focus on specific modelling aspects relating to back-testing of value-at-risk (VaR) models, VaR and stressed VaR methodologies, incremental risk charge methodology and a framework for risks not captured in the model engines (known as RNIME).

The counterparty credit risk chapter outlines the ECB's understanding of the regulatory requirements defined for the Internal Model Method (IMM), as referred to in Part Three, Title II, Chapter 6, Section 6 of the CRR. In order to ensure that these requirements are applied consistently, the chapter provides guidance on the main qualitative and quantitative aspects of the IMM.

The advanced method for credit valuation adjustment capital requirements is currently not in the scope of the ECB guide to internal models.

What is the link between the ECB guide to internal models and the TRIM guide that was published in February 2017? Why is the name different?

The ECB guide to internal models is a refinement of the [TRIM guide](http://www.ecb.europa.eu/ecb/pub/pdf/trim_guide.en.pdf) ([Link to: http://www.ecb.europa.eu/ecb/pub/pdf/trim_guide.en.pdf](http://www.ecb.europa.eu/ecb/pub/pdf/trim_guide.en.pdf)) that was made available on 28 February 2017 for early industry feedback. The revised version benefits from the comments received from institutions. It also takes into account the experience gained in the on-site supervisory investigations conducted in 2017 and 2018 in the context of the TRIM project. The version of the guide that is currently being consulted on will serve as a reference for future internal models investigations, including those beyond the scope of TRIM. It will be updated as appropriate to reflect changing regulatory requirements and supervisory stances on internal models.

What are the main differences compared with the previous version – the TRIM guide – published in February 2017?

In terms of overall structure, the updated version of the ECB guide to internal models that has now been published for consultation does not differ significantly from the version published in February 2017. The main difference concerns the section on data quality, which was included in the general topics chapter of the TRIM guide (under Section 9) and has now been moved to the credit risk chapter of the ECB guide to internal models. The data quality section has been further updated, but the changes mainly relate to minor amendments to provide further clarification as well as some editorial changes (e.g. order of the sub-sections).

In terms of the content of the individual chapters, the following main changes are worth highlighting.

The credit risk chapter has been updated to refine the content relating to the retail and small and medium-sized enterprise portfolio topics and to incorporate new areas developed to cater for the specificities of low-default portfolios (including medium-size and large corporates, financial institutions and specialised lending). In relation to retail and SME portfolio topics, the refinements take into consideration the experience gained through the TRIM on-site investigations.

The changes to the market risk chapter mainly concern a revised section on the framework for RNIME, as well as a refined definition of actual and hypothetical profit and loss in regulatory back-testing.

Finally, the main change in the counterparty credit risk chapter relates to alternative exposure calculations (previously labelled fall-back solution). The new version of the guide proposes two alternative principles for the treatment of these exposures. The industry is expected to comment on both proposals and to express a preference on which of the two should ultimately be included in the guide.

What is the next step after this consultation on the chapters of the ECB guide on internal models?

The ECB guide to internal models will be updated after the industry feedback has been incorporated.

Once the consultation process is finalised, will the guide be updated in the future?

Yes. Some parts of the guide may require revision or expansion, for example if the supervisory criteria or the regulatory requirements change. Future updates of the ECB guide to internal models may be released without being put out to further public consultation.

Could some of the principles presented in the guide differ from or add to previous supervisory practices?

One major objective of ECB Banking Supervision is to ensure the consistent application of high supervisory standards and practices across the euro area. Therefore, some principles presented in the guide may differ from, or add to, practices and stances applied before the Single Supervisory Mechanism was set up. However, when the ECB applies the relevant rules, the specific circumstances and features of each institution will be taken into due consideration. It is worth noting in this respect that the content of the guide has been developed in close cooperation with the National Competent Authorities.