

ISDA

International Swaps and Derivatives Association, Inc.
One New Change
London, EC4M 9QQ
United Kingdom

Telephone: 44 (20) 7330 3550
Facsimile: 44 (20) 7330 3555
email: isda@isda-eur.org
website: www.isda.org

New York
Telephone: 1 212 901 6000
Facsimile: 1 212 901 6001

Singapore
Telephone: (656) 538-3879
Facsimile: (656) 538-6942

Tokyo
Telephone: 81 (3) 5227-3282
Facsimile: 81 (3) 5227-3283

Meeting with AIG Members on Validation

- Montreal, June 18th, 2003 -

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Attendees from the AIG:

Chairman:	Nicholas Le Pan
Belgium:	Patrick Massin Claire Renoirte
Canada:	Lorey Hoffman Robert Hanna Ben Gully Laural Ross
France:	Alain Duchâteau Didier Elbaum C K Tran
Germany:	Erich Löper Hans-Joachim Dohr Thilo Liebig (for the RTF)
Italy:	Andrea Pilati
Japan:	Junji Hiwatashi Kozo Ishimura
Luxembourg:	Romain Strock
Netherlands:	Rinus van der Struis
Spain:	Cristina Iglesias Juan Serrano Gregorio Moral
Sweden:	Kristian Bentzer
Switzerland:	Daniel Sigrist
United Kingdom:	Stephen Bland Andrew Gracie Kevin Ryan
United States:	Stephen Hoffman John Lane Brian Peters Douglas Roeder Mark Levonian
European Commission:	Vittorio Pinelli
Groupe de Contact:	Fernando Vargas
Financial Stability Institute:	Roland Raskopf
Secretariat:	Antonio Pancorbo Bob Maahs

ISDA Representatives:

Mr Alan Hilton	Barclays	UK
Mr Ed Duncan	ISDA	UK
Sebastian Fritz	Deutsche Bank	Germany
Mr Jonathan Gray	Royal Bank of Scotland	UK
Ms.Lyn McGowan	RBC Financial Group	Canada
Mr Michel Crouhy	CIBC	Canada
Larry Mielnicki	Fleet	USA

Background

ISDA, along with the RMA and the BBA, were invited to attend the June meeting of the Accord Implementation Group (AIG) to present the results of the Internal Ratings Validation Study. The meeting was chaired by Nick Le Pan and comprised 35 regulators from the G10 countries. The 3 Associations invited both retail and corporate specialists who participated in the Study from Europe and North America. The Study was published in the second week of June, and all regulators and firms present were sent advanced copies of the report.

An audience with the AIG would represent the first truly international discussion on validation between regulators and the industry.

The meeting took place on Wednesday June 18th at the Intercontinental Hotel in Montreal and was scheduled to last 3 hours starting at 14:00hrs

Key Messages from the meeting:

- As with our meeting with the AIG in Washington on Data issues back in April, only the North American regulators contributed to the discussion (with the exception of one question from the French, no other regulators made any comment)
- The AIG will not be issuing any guidance on validation (the AIG does not want to add to the already extensive rules on Pillar 1)
- The AIG cannot promise a “level playing field”, but instead refers to a tolerance level for broad scope interpretation.
- Regulators were struggling with providing the industry enough flexibility in implementation whilst staying true to the requirements of the Accord.
- Validation is not a science and is evolving all the time.
- Validation cannot be a purely statistical exercise.
- Firms must take full responsibility for validation. The AIG confirmed that National Regulators will be looking to “validate the validation”, and not attempt to undertake it themselves.
- The AIG is very interested in hearing from the industry and hearing about possible solutions to validation problems.

Summary

ISDA and the RMA gave a brief overview of the background and workings of the Study. This included an explanation of why the Survey was in two-parts (Generic and Asset Specific) and also an explanation of why the statistics, and in particular the totals, vary throughout the Study (26 Banks participated, but e.g. we had 30 responses for the Retail Class). We also briefed the AIG on the need, right from the beginning, to define the different Internal Ratings Systems in place and to distinguish between Asset Classes and Model Types.

The Royal Bank of Canada (RBC) described the terminology used in the Survey and stressed the need for consistency in terminology across international regulators. RBC went on to describe the Asset Classes, the Model Types (the key distinction between Hybrid, Expert Judgement and Constrained Expert Judgement Models), the Master Scale (usually between 10-20 grades), the Definition of Default, the Rating Alignment, and Documentation of Internal Ratings (a more recent development).

The key messages contained in the Executive Summary to the Study were discussed.

Validation of Internal Ratings did not fit into a “one size fits all approach”. This conclusion was broadly in line with the discussions held at the AIG in the same week, and with other work on the subject that had been undertaken (e.g. Research Task Force paper – publication?)

The AIG would share information among its members with a view to understanding and minimising divergence.

Detailed Notes:

Definition of Default

The AIG asked the industry what people were doing with the Definition of Default with regard to loan sales and whether they are distressed or not (e.g. does a loan with a value of 100, sold for 98, count as a distressed sale, and therefore under the Accord, a default?). Although this was not covered in the Study, the group stated that there was no industry wide threshold for distressed loan sales. Deutsche Bank recognised that this was a problem, and although RBC commented that they had redefined Default to include certain loan sales, they were not included historically.

Assessment Horizons

On Assessment Horizons Nick Le Pan observed that different time horizons would be used for different portfolios within the same institutions. The AIG went on to suggest a possible link between the use of different time horizons and Pillar 2 Stress Tests? There was some willingness on the part of the AIG to accept where ratings use different time horizons recognising the different uses that ratings have within the business. With regard to validation, Deutsche Bank suggested that the frequency in which validation occurs has become more formalised, but will vary across rating systems (e.g. residential mortgages may not need to be validated every 6m?). How often you validate will depend on the portfolio.

There was then a discussion employing the dreaded “point-in-time” and “through-the-cycle” terminology. This was not directly related to validation. The AIG wondered how they might validate ratings systems without employing such terminology. Barclays described the two-stage process, as outlined on page 28 of the Study, involving (i) an initial evaluation of the factors to be used in the rating model, followed by (ii) a calibration of the PD, considering such factors as rating agency data, judgmental overlay, portfolio factors, internal default rates, economic environment etc. This led to the recognition on behalf of the AIG that validation cannot be a purely statistical exercise.

Model Validation

The AIG recognised that statistics are not always appropriate in validation, and that there is a need to consider other issues, possibly focussing on expert judgement. CIBC noted that it would be impossible to transpose a Market Risk framework (back testing) for Credit Risk. Fleet suggested that the OCC guidelines (2000-16) were appropriate for the assessment and validation of models. These guidelines considered the model pre-implementation and then post-implementation considering such factors as population stability, model characteristics, and portfolio and vintage analysis. Fleet and the OCC stressed the importance of looking at the logic, consistency, and appropriateness of the model design and requirements.

External Vendor Models

The AIG (OCC) raised the question of how you validate External Vendor Models. A number of attempts by the group present were shared with the AIG (back testing of KMV, RiskCalc and Fair Isaac type models) with varying degrees of success, with the main concerns being around availability of data and calibration. There is also significant industry concern, as raised by RBOS, that firms will be required to undertake multiple and repetitive validations of external models across jurisdictions. Nick Le Pan suggested that trade bodies could help in this respect moving forward.

Asset Classes

Barclays introduced the results of the Study across the Asset Classes, noting that we had received 124 responses across the different asset classes from the 26 banks. Validating Banks and Sovereigns still remained the biggest challenge. The group stressed that the Basel framework did not work for high quality portfolios. The Corporate Asset class displayed the full range of practise but it was noted that judgemental models were prevalent throughout the responses.

Expert Judgement

Validation of Expert Judgement models needs to be consistent. How can consistency be developed in such an environment? There is clearly a need for more work to be done in this area, and as the Study has shown expert judgement plays an important part in the majority of internal ratings systems.

Role of Internal Audit

Nick Le Pan asked the group whether they felt that the independent validation of models needed to be enhanced. At least one member of the industry group described development, creation, calibration, and validation of the model as integral parts of internal rating systems. The member expressed concern that if you prescribe rules separating these functions out, then the results of the validation process are more difficult to feedback into the model development and calibration or re-calibration. The AIG were clearly concerned about the role of internal audit and admitted to not really knowing what the right balance of checks and balances was going to be required.

Stress Testing

There was a brief discussion on Stress Testing, which was not always related to validation and highlighted the confusion among regulators around the objectives of and requirements for stress tests. The group shared with the AIG examples today of scenario analysis around geo-political events (Oil prices, War in the Middle East etc), along with localised stresses and correlation testing. Fleet expressed little appetite for defined stress tests

ENDS.