IRB models

An industry perspective

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Agenda

1 **Why do banks use internal models?**
Motivation and benefits

2 **What could possibly go wrong?**
Risks and challenges

3 **What's next?**
Trends and upcoming challenges

Why do banks use internal models?
Motivation and benefits

Banks in Europe have been progressing towards IRB models for the last 20 years, and to a large degree are willing to remain in AIRB/FIRB as much as possible

Reasons to go to IRB models (and to stay there)

1. **Supervisory incentives** (e.g. minimum EAD coverage)
2. **Direct benefits**
   - RWA optimization and lower cost of capital
   - Higher, more precise risk sensitivity
   - Use test fosters better risk management
3. **Indirect benefits**
   - Avoids a competitive disadvantage (drifting off the market)
   - Supervisory scrutiny yields better models and better data
   - Better understanding of supervisor's requirements, supervisory dialogue
4. **Industry-level benefits**
   - Level playing field, reduction of undue competitive advantage, within harmonized jurisdictions
   - Incentivizes credit to the real economy (IRB banks have lower RWs)
   - Perceived consistency, standardized methodology (e.g. ITT)

What could possibly go wrong?
Risks and challenges

Although benefits are indisputable, in hindsight the process is challenging and costly

Challenges for banks

1. **Investment**
   - Long-term, high-uncertainty investment (necessary business case)
   - Organizational setup (three LoDs, independence, dedicated functions, Internal Audit, consultants)
   - Need for specialized profiles (regulation + business + data + quant), painfully scarce in the market
   - Data (availability, quality, consistency, traceability and integrity) and technology (DWHs, DMs, tools)
2. **Governance and risk management**
   - Strong senior management involvement
   - First adoption of IRB models has heavy focus on risk management and governance (e.g. ECB general topics)
3. **Regulatory risk (bounce-back, return to compliance)**
   - Trend towards sophistication reverted to simplification (e.g. LDP, ULDP, AMA) – and simplifying is costly too
   - Need for precision in regulation (e.g. MoC, CRR Art. 179 1f vs. EBA GL MoC)
   - Delays in approvals (supervisory availability)
   - “Return to compliance” effectively bumping up capital levels in Europe – unexpectedly vs first adoption
4. **Supervisory process (missions)**
   - Missions perceived as highly time- and resource- consuming, sometimes overlapping
   - Distraction from daily activities, accumulation of regulation – leads to a perception of “compliance as sole priority”

What's next?
Trends and upcoming challenges

The future seems to bring yet more challenging topics, promising to keep the industry awake, but also to consolidate a solid and resilient banking system

Six topics coming our way

1. **Rationalization of model map and model complexity** (balance between sophistication and simplification)
2. **Semi-automation of processes; efficiency as the next goal**
3. **Model risk management** (major failure of banks' MRM during covid)
4. **Convergence between IRB and IFRS 9 models**
5. **ESG integration into credit risk models** (e.g. ESG scores, taxonomy, carbon emissions, 30y+ horizon stress tests)
6. **More sophisticated techniques** (ML/AI)

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