

28 October 2022

**Consultation paper on supervisory handbook on the validation of rating systems under the Internal Ratings Based approach**

***ITALIAN BANKING ASSOCIATION RESPONSE***

Please find below some comments on paragraph 1.2 of the consultation paper, concerning the independence requirements of the validation function, and a point of clarification concerning the interaction between the IA and the validation function in the assessment of rating systems.

**The validation function as a second layer of defence, between CRCU and Internal Audit (para 1.2)**

The consultation paper confirms that the validation function should be independent from the credit risk control unit (CRCU) in order to allow for an objective assessment of the rating systems, a limited incentive to disguise the model deficiencies and weaknesses, as well as a fresh view on the rating systems by people not involved in the development process.

In this regard, the validation function is required to assess the final model developed by the CRCU “as a second layer of defence”, by challenging in an independent manner the model design and methodological choices made by the CRCU during the model development.

In order to ensure no subordination linked to the CRCU, the consultation paper sets two criteria concerning the organizational set-up and the sufficient resources allocation.

As for the organizational set-up, in compliance with article 10 of the Commission Delegated Regulation (EU) 2022/439, the consultation paper defines three different options, depending on the nature, size and scale of the institution and the complexity of the risks inherent in its business model:

1. The validation function is in a unit separated from the CRCU and both units report to different members of the senior management;
2. The validation function is in a unit separated from the CRCU, but both units report to the same member of the senior management;
3. The validation function is not in a unit separated from the CRCU, but the staff performing the validation function is different from the staff responsible for the design and development of the rating system and from the staff responsible for the CRCU.

Nevertheless, it is expected that large and complex institutions apply the setup which provides the highest level of independence of the validation function, as specified in point 1 above, although the Regulation 2022/439 explicitly allows such institutions to choose from the first two options.

More specifically, according to the Regulation 2022/439, in large and complex institutions the CRCU and the validation function - which is required to be set as a unit separated from the CRCU - can report to different members of the senior management or to the same member of the senior management. In the latter case further measures are to be adopted by the institution in terms of adequacy of the decision-making process, level of compliance with the corrective measures requested by the validation function and controls by the internal audit.

**In this regard, it is not clear why the consultation paper does not allow the large and complex institutions to freely choose between the above two options, as permitted by the Regulation 2022/439.**

Please note that, according to some national laws (i.e. Italian Bank of Italy supervisory provisions), the validation function is located - as an independent unit - within the risk control function and reports to the chief risk officer. A different organizational position of the validation function should not be allowed.

This organization set up is adopted by the main Italian listed banks as well as other European banks, being also consistent in terms of organizational efficiency. Just consider that the chief risk officer is required to possess adequate skills and experience in his/her area of expertise, including the development and control of internal models.

It is also worth noting that the complete separation of the internal validation and the CRCU, reporting to different members of the senior management, raise issues from a business organizational perspective, being it necessary to locate the internal validation function within a different area ensuring an adequate and consistent level of independence especially from the business.

The above issues lead to reconsider the proposed approach, by allowing large and complex institutions to choose between option 1 and 2, as provided by the Regulation 2022/439.

In any case, in order to further strengthen the independence of the internal validation function, the appointment of the head of the function by the management body [in its supervisory function] could be positively assessed by the Authority.

In light of the above, we ask to provide for the following amendments of section 1.2, paragraph 18:

[.....]

This independence is ensured via two criteria:

a. The structural independence ensured via the organisational setup (see Interaction box [1]). In this regard, it is expected that large and complex institutions apply the setup which provides the highest level of independence of the validation function **by adopting one of the permitted options** (Point 1 **and 2** of Interaction box [1]) **and requiring the management body to appoint the head of the internal validation function**. [...]

### **Interaction between the IA and the validation function in the assessment of rating systems**

Considering paragraphs n. 22 (C), n. 85 and interaction boxes 4 and 9, with reference to the supervision carried out by the Internal Audit function in the area of model implementation, in the event that this is not carried out by the internal validation function, it could be useful to specify if this supervision must necessarily be carried out by the level III control function in "ex-ante" mode for each model.