

## Credit risk models-related policies

1. The Prudential Authority (PA) issued a consultative paper titled 'Policy guidance on credit risk models-related matters' to solicit comments from industry on various matters related to the internal ratings-based (IRB) minimum requirements. After consultation, the policies in this document will form the basis of a guidance note, which the PA intends to issue in terms of section 6(5) of the Banks Act 90 of 1994 by December 2021.
2. In the main, the paper has two key objectives, namely:
  - 2.1. to articulate and communicate the PA's proposed policy positions on various minimum requirements, specifically with regard to its expectations of the evidence IRB banks should produce when submitting credit risk models for approval prior to implementation; and
  - 2.2. to provide an outline of technical factors relating to the minimum requirements that IRB banks should take into account when developing and validating their credit risk models, and the expected documentary evidence that banks should produce to demonstrate compliance.
3. The paper covers various topics, but in brief focuses on the following:
  - 3.1. Documentation of model development and validation evidence: Given that these documents serve as an important basis for the model review process, it has been a concern that certain technical aspects of the models are not always documented properly and consequently make the independent review process challenging. Therefore, the aim in this regard is to articulate the PA's overall expectations and explicit requirements of what and how certain elements of the credit risk models should be documented.
  - 3.2. Validation provides an additional layer of assurance to the PA in that models submitted for approval evidence acceptable performance and are fit for use. In this regard, this paper proposes various minimum qualitative and quantitative tests which IRB banks should produce evidence of to validate their acceptable performance and fitness for use.
  - 3.3. Data is an important ingredient for producing high-quality models, and this is particularly a challenge for those portfolios experiencing low default and loss events. Similarly, this paper proposes various qualitative and qualitative considerations in line with the minimum requirements banks should take into account when relying on external data sources as well as the evidence they should produce to demonstrate representativeness and compliance with regulatory requirements.

- 3.4. Governance and evidence of challenge: The minimum requirements reserve important oversight responsibilities for senior management and board of directors with regard to the development and implementation of credit risk models. Moreover, prior to submission to the PA, credit risk models should go through various internal approval committees. These approvals should be more than a rubber stamp and provide an opportunity for various stakeholders in IRB banks – ranging from model developers, validation teams and users – to challenge the models from conceptual soundness, performance and adherence to business experience perspectives. In this regard, this paper outlines the evidence the PA will expect as demonstration of the rigour of the approval processes.