# Chapter 4

# Credit risk

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## 4.10 Validation

4.10.1 | G | The *FCA* expects a *firm* to have a validation process that includes the following:

(1) standards of objectivity, accuracy, stability and conservatism that it designs its ratings systems to meet and processes that establish whether its rating systems meet those standards;

(2) standards of accuracy of calibration (ie, whether outcomes are consistent with estimates) and discriminative power (ie, the ability to rank-order risk) that it designs its rating systems to meet and processes that establish whether its rating systems meet those standards;

(3) policies and standards that specify the actions to be taken when a rating system fails to meet its specified standards of accuracy and discriminative power;

(4) a mix of developmental evidence, benchmarking and process verification and policies on how this mixture varies between different rating systems;

(5) use of both quantitative and qualitative techniques;

(6) policies on how validation procedures are expected to vary over time; and

(7) ensuring independent input into, and review of, its rating systems (see article 188 of the *UK CRR*).

4.10.2 | G | In ■ IFPRU 4.10.1 G:

(1) developmental evidence means evidence that substantiates whether the logic and quality of a rating system (including the quantification process) adequately discriminates between different levels of, and delivers accurate estimates of, PD, EL, LGD and conversion factors (as applicable); and

(2) process verification means the process of establishing whether the methods used in a rating system to discriminate between different levels of risk and to quantify PD, EL, LGD and conversion factors are being used, monitored and updated in the way intended in the design of the rating system (see article 188 of the *UK CRR*).

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**4.10.3**  |G|  The *FCA* expects a *firm* to be able to explain the performance of its rating systems against its chosen measure (or measures) of discriminative power. In making this comparison, a *firm* should rely primarily on actual historic default experience where this is available. In particular, the *FCA* expects a *firm* to be able to explain the extent of any potential inaccuracy in these measures, caused, in particular, by small sample size and the potential for divergence in the future, whether caused by changing economic conditions or other factors. *Firms*' assessment of discriminative power should include appropriate use of external benchmarks where available.

**4.10.4**  |G|  The *FCA* will take into consideration the sophistication of the measure of discrimination chosen when assessing the adequacy of a rating system's performance.

**4.10.5**  |G|  In the case of a portfolio for which there is insufficient default experience to provide any confidence in statistical measures of discriminative power, the *FCA* expects a *firm* to use other methods. For example, analysis of whether the *firm's* rating systems and an external measurement approach (eg, external ratings) rank common obligors in broadly similar ways. Where such an approach is used, the *FCA* would expect a *firm* to ensure it does not systematically adjust its individual ratings with the objective of making them closer to the external ratings as this would be counter to the philosophy of an internal rating approach. The *FCA* expects a *firm* to be able to explain the methodology it uses and the rationale for its use.