

Summary of Principles Underlying “Validation” of Rating Systems

In the context of IRB systems, the AIG Validation subgroup has defined the term “validation” to encompass a range of processes and activities that contribute to an assessment of whether ratings adequately differentiate risk, and whether estimates of risk components appropriately characterise the relevant aspects of risk. The following is a summary of the principles that underlie the concept of validation of IRB systems, as agreed to by members of the subgroup in June 2004¹:

Principle 1: Validation is fundamentally about assessing the predictive ability of a bank’s risk estimates and the use of ratings in credit processes

Principle 2: The bank has primary responsibility for validation

Principle 3: Validation is an iterative process

Principle 4: There is no single validation method

Principle 5: Validation should encompass both quantitative and qualitative elements

Principle 6: Validation processes and outcomes should be subject to independent review

¹ The AIG Validation Subgroup intends to publish these principles in a Newsletter that will be available on the BIS website in due course.