Panel Discussion:

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Validation Questions

- Always: What should the model be doing?

- At Implementation: Does the model do what we think it should be doing?

- Ongoing: Does the model still do what we think it should be doing?

- Ongoing: Could we be doing what we are doing better? (Is anyone else doing it better?)

Reasons for Validation

- Bankers:
  - Satisfy the supervisors
- Supervisors:
  - Make sure banks understand risk, improving safety and soundness (and indeed guaranteeing fairness).
- Enlightened Bankers:
  - Manage risk effectively; compete fiercely without taking undue (i.e. unknown) risks

- Perhaps the bankers, especially those in group one, are most concerned w/ supervision, and the supervisors with safety and soundness.

Transparency

- Does <u>not</u> require that every institution use the same model, or the same approach
- Differences in approaches, models, and estimation techniques across banks may be appropriate (subject to rationality constraints)
- These differences can generate information on best practices, provided that common definitions are used, and that common validation techniques are used.
- Bank's investments in modeling and validation promote the academic agenda of discovery ...
- Perhaps generating short-run competitive advantages on the side.
- Does not require full disclosure of models or parameters as much as disclosure of methods for modeling and of validation results.

How to Promote Transparency

- Uniform and meaningful definitions: PD, LGD, "credit score"

- Promulgation of best practices (everyone should have a working model).

- Uniform diagnostics and model validation methods.

- Not necessarily uniform models!

- Ultimately, (in the long run?) modeling, validation, and communication of the results are management responsibilities which will be judged in the financial markets.

- Perhaps the long run comes slowly (hence the workshop).

Another Role for Validation: Market Discipline

- Economists concerned with efficiency and social welfare think in terms of full information or transparency.

- Market pressure selects best practices and leads to efficient capital allocations, with all the associated positive welfare effects.

- Model validation, including disclosure of the validation history, is crucial to transparency.

- Who should be convinced that the models work? Bankers and supervisors, sure.

- Also, shareholders, debt holders, customers, business counterparties, etc.