



Observations of internal model validation

During its recent internal model review work the PRA has observed varying approaches to the role of validation in internal models. In order to assist firms with preparations for formal internal model applications the PRA sets out below three of these observations.

1. Internal model tests and standards are designed to ensure that a model is well grounded in its technical content, with good sources of underlying data. The tests and standards also require that the model and its limitations are properly understood by its users and by senior management at firms, including the Board level.
2. The PRA does not expect Boards or senior management to be able to discharge their duty in isolation. Boards should demand support from executive management to ensure that key features of models are explained in a way that Directors can properly engage with, and they should draw on a wide range of sources, not limited to model developers, to ensure they are satisfied with the model.

The PRA would anticipate that validation of the internal model clearly evidences the review and challenge that has taken place in assisting the Board meet its objectives.

3. The PRA has also observed that whilst model justification and validation are two separate processes and represent important components of the Solvency II requirements their implementation by firms has become somehow blurred.

Model justification, as part of the internal model development, is often covered by the validation using a bottom up approach. This has tended to approach the question from the perspective of justifying “why are our modelling choices reasonable and defensible”? The bottom-up approach the PRA has seen to date does not adequately fully cover the validation objectives nor does it help Boards and senior management get an adequate understanding of the model.

A comprehensive validation should put specific attention to those *key assumptions and expert judgments that have a material impact on the model*, and should also articulate how the sensitivity to the key assumptions and expert judgement are being assessed and taken into account in the decision process.