# CREDIT UNDERWRITING MODELS: NEED FOR VALIDATION

## Meaning of credit underwriting models:

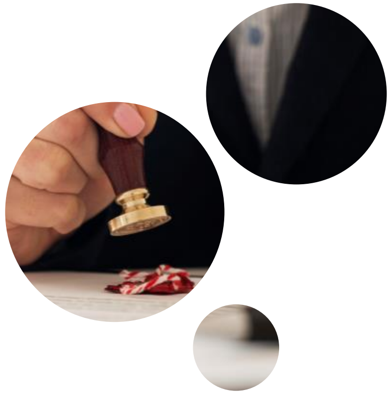
- Every entity has different credit products, and it follows different approaches for different product segments - based on granularity, ticket size, turnaround speed, security features, etc.
- Credit underwriting model means the structured approach that a lender follows for the underwriting decision. A model does not have to be a technology tool - for example, it may be a traditional committee approach where financial and non-financial information is collected in the form of a credit approval memo, and then reviewed by a committee.
- However, credit underwriting is increasingly becoming model-dependent, particularly in case of fintech lending entities.

## Need for validation of credit underwriting model

- Every model needs to undergo a process of validation at its introductory stage and thereafter, consistently over time to get feedback, carry out refinements, backtesting etc.
- Entities that rely on models for credit underwriting stand to the risk of creating credit risk, which may grow significantly before it gets observed or mitigated.
- Hence, the need for a continuing validation of these models.

## How is the validation done:

- Focus on the critical risk parameters captured by the model, and their respective weightage in the scoring/internal rating approach; see the relevance of these parameters in the risk of performance of the borrower.
- See the empirical performance of the borrowers based on each rating or rating band, and in particular, see the cases of defaults.
- See the causative factors of the defaults and see if this information could have been fed into the underwriting model



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- **External vs Internal validation:**
  - Validation of the credit underwriting model is the key responsibility of the credit underwriting team, and one of the important duties of the risk committee. Therefore, internal validation, on a continuous basis, is an internal responsibility.
  - However, sometimes external validation may be helpful, given the fact that an internal rating model gets independently checked and tested if it passed through external validation. The external validation must be done as per a board-approved validation framework.

- **Validation Framework:**

Framework may consist of –

- Analysis of different credit products, particularly distinguishing those that are dependent on models/technology tools/ platforms
- Review of model assumptions
- Review of data points collected and the weight assigned to each
- Review of the approval thresholds, in particular, focus on the extent of rejections by the underwriting team
- Testing the model
  - Use of historical data for backtesting
  - Use of scenarios/ stress testing
- Recommend improvements based on result of the tests

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