

Governance of Internal Ratings Based and Advanced Measurement Approaches

Governance of Internal Ratings Based (IRB) approaches to credit risk

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Background

1. The Capital Requirements Directive (CRD) requires the management body¹ or a ‘designated committee’ thereof to approve all material aspects of rating and estimation processes². In CP05/3 and CP06/3, we copied out this CRD requirement into *BIPRU*:

4.3.9R All material aspects of the rating and estimation processes must be approved by the *firm's governing body* or a *designated committee* thereof and senior management. These parties must possess a general understanding of the *firm's rating systems* and detailed comprehension of its associated management reports.

2. We also consulted in CP06/3 on a *BIPRU* Glossary definition of ‘designated committee’ such that it should include at least one board member:

designated committee (in relation to a *firm*) a management body of the *firm* with delegated authority from the *firm's governing body* for approving either:

- (a) (in relation to a *firm* that uses the *IRB approach*) all material aspects of the *rating* and estimation process in relation to the *IRB approach*; or
- (b) (in relation to a *firm* that uses the *AMA approach*) all material aspects of the *AMA approach* as carried out by the *firm*;

at least one of whose members is a member of the *firm's governing body*.

1 CRD nomenclature for governing body.

2 Paragraph 123, Section 5.1, Part 4, Annex VII.

3. In FS05/1 and CP06/3, we explained that we considered this definition to be necessary to ensure that adequate review and challenge of rating systems occurred at a sufficiently senior level.

Industry responses to CP06/3

4. We received three responses on the proposed definition of ‘designated committee’, including the trade associations’ joint response. All were opposed to the proposed definition, asserting that it was disproportionate and overly-prescriptive. The respondents argued that firms should have the freedom to define risk management governance arrangements for themselves. In addition, they felt such approval was more appropriately handled by lower-level, specialist committees, with regular reporting and updates received by the board.

Superequivalence of the proposed definition

5. The responses of the trade associations and one firm suggested that the proposed *BIPRU* Glossary definition – requiring that at least one member of the firm’s governing body be a member of the ‘designated committee’ – was superequivalent. Our General Counsel’s Division has advised us that this is not the case.

Proposed way forward

6. Having reflected on the CP06/3 responses, we remain of the view that it is appropriate to define ‘designated committee’ such that it must include at least one member of the firm’s governing body. We believe this is both a requirement of the CRD and necessary to ensure senior executives’ effective review and challenge of a firm’s IRB rating systems.
7. However, we are also sensitive to respondents’ concerns about the need for the application of the definition to be practical and proportionate. We need to strike an appropriate balance between meeting the CRD’s IRB governance requirements and industry concerns about proportionality and practicality. Therefore, in the feedback statement on CP06/3 we plan to:
 - confirm our view of the appropriateness of the ‘designated committee’ definition proposed in CP06/3;
 - clarify that we will require the ‘designated committee’ to approve only the firm’s ‘material’ IRB rating systems, and that this review should go beyond approving the operational processes in place to ensure the adequacy of the firm’s rating systems³;
 - confirm that it is for firms to define the number, and nature, of IRB rating systems that qualify as ‘material’;
 - make clear that we would expect the ‘designated committee’ also to approve a high-level policy statement defining its overall approach to material aspects of rating and estimation processes in respect of all rating systems; and

3 It would be reasonable for firms to use recommendations or reviews of lower level committees as an input into this review and challenge process.

- leave firms to determine for themselves the appropriate governance arrangements for non-material rating systems.

Understanding of rating systems

8. It should be noted that the CRD and *BIPRU* 4.3.9R requirement for ‘general understanding’ of the rating system applies to the governing body irrespective of whether or not a ‘designated committee’ is used to approve rating systems. As stated in FS05/1, we would expect the ‘general understanding’ requirement to apply to a firm’s governing body as a whole, rather than to each of its individual members. In addition, as part of the waiver process, we will expect firms to be able to explain how in practice they intend to meet the requirements for ‘general understanding’ and ‘good understanding’ of rating systems.

Governance of Advanced Measurement Approaches (AMA) to operational risk

Background

9. In CP06/3 we proposed also to apply the ‘designated committee’ definition to AMA. We considered this necessary to ensure:
 - sufficient senior input into, and review and approval of, AMA; and
 - consistency with our approach to IRB governance.
10. The CEBS paper on validation has now been published and we can confirm that our proposal is already a minimalist implementation of the guidelines that CEBS has set down. Our proposals are also less stringent than the Sound Practices for the Management and Supervision of Operational Risk of the Basel Committee, which is being adhered to by most other countries.

Industry responses

11. Our proposal was described as superequivalent and disproportionate in the trade associations’ joint response. At the Operational Risk Standing Group on 13 June 2006, we advised that we would expect the operational risk governance issue to be decided on the basis of the approach for IRB.

Proposed way forward

12. Having reviewed the CP06/3 responses, we remain of the view that applying the ‘designated committee’ definition also to AMA is important in order to ensure senior input and challenge. Other regulators also believe that, particularly given that AMAs are not yet as embedded in industry practice as are credit risk approaches, it is particularly important for AMAs to be reviewed by a ‘designated committee’ or the board itself. We have some sympathy with this view and believe that our proposals are a justifiable requirement to

minimise the risk of the use test being undermined as a result of a lack of board involvement. Dropping the proposed requirement would make us an unjustifiable outlier in terms of the application of the operational risk governance requirements included in the CEBS Validation Guidelines. The feedback statement on CP06/3 will explain this approach.

13. As indicated in paragraph 7 we are sensitive to respondents' concerns about the need for the application of the definition to be practical and proportionate. We therefore plan to move forward in line with our proposals in paragraph 7, to:

- confirm our view of the appropriateness of the 'designated committee' definition proposed in CP06/3;
- clarify that we will require the 'designated committee' to approve only the firm's 'material' AMA elements⁴, and
- make clear that we would expect the 'designated committee' also to approve a high-level policy statement defining its overall approach to material aspects of operational risk management.

⁴ It would be reasonable for firms to use recommendations or reviews of lower level committees as an input into this review and challenge process.