
To: CRSG Date: 31 October 2005

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Subject: **Governance requirements under the IRB Approaches**

Key points

- A number of firms have requested clarification on our expectations of senior executives in respect of IRB rating systems.
- In Chapter 18 of FS 05/1 (http://www.fsa.gov.uk/pubs/cp/fs05_01.pdf), we responded to industry feedback on senior management issues. In this chapter we clarified definitions and stated that we would consult in the February CP on additional guidance in respect of the IRB governance requirements on senior executives.
- Included in the appendices to this note is proposed guidance on a *general* and a *good understanding* on which we would now like to pre-consult. We would welcome the views of the industry on the appropriateness and proportionality of this proposed guidance.

Definition of *designated committee*

1. We stated in FS 05/1 that we would consider whether to clarify in additional guidance or the Handbook definitions our expectation that a *designated committee* used to approve IRB rating systems should include at least one member of the firm's *governing body*. We considered this to be necessary in order to ensure that the challenge and approval of rating systems occurs at a sufficiently senior level.
2. The following is a proposed Handbook definition of *designated committee* responsible for approving IRB rating systems.

Designated committee

The body of management with delegated authority for approving all material aspects of the rating and estimation process. This body should comprise at least one member of the firm's *governing body*.

Question for the CRSG on the definition of *designated committee*

- Does this definition adequately clarify our expectations of membership of a *designated committee*? How might it be improved?

Level of understanding of senior executives

'General' understanding of governing body or designated committee

3. In FS 05/1, we stated,

Our principal concern is that a general understanding of rating systems should fall within the overall competence of the governing body as a whole, and the designated committee as a whole. This understanding should be sufficient to allow for effective challenge, and enable them to take reasoned decisions on the matters presented to them. It should go beyond an understanding of the processes in place within a firm or group to ensure the adequacy of its rating systems. For rating systems which a firm considered to be material to its business, it could include an awareness of, for example:

- the nature of the rating systems themselves;
- the products and customer segments covered by the rating system;
- the materiality of the rating system to the firm or group;
- at a general level, the rating systems' key strengths and weaknesses;
- the level of performance that the firm considers to be adequate for such rating systems;
- the role of the Credit Risk Control Unit and internal audit in ensuring the performance of rating systems; and
- the process within the firm and group to monitor and ensure adequate performance on an ongoing basis.

We would expect this general level of understanding to have been reached at the time of approval of the rating systems. In addition, it should be refreshed periodically, by way of the management and exception reporting on the rating systems provided to the governing body and designated committee, and by ongoing briefings and training.

4. Appendix 1 comprises the 'copied-out' *BIPRU* requirement and the additional guidance on which we are pre-consulting. This includes consideration of what is meant by the 'nature of the [material] rating systems themselves'.

'Good' understanding of senior management

5. In FS 05/1, we did not provide examples of what a *good understanding* might entail. However, we stated that we would do so in the form of additional guidance in the February CP. Appendix 2 comprises the current *BIPRU* requirement in this area, and proposes draft additional guidance to clarify the principle.

Questions for the CRSG on *general and good understanding*

- To what extent does the proposed additional guidance adequately clarify our expectations of a *general* and a *good understanding*?
- To what extent does the guidance capture the areas that a board / designated and senior management should understand? How might it be improved?

APPENDIX 1: draft additional guidance on the *general understanding of the governing body or designated committee*

6. Currently, the *BIPRU* text in this area is as follows¹:

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

Proposed additional guidance

- 4.3.XG
- (1) **This paragraph provides *guidance on BIPRU 4.3.9G.***
 - (2) **Where a *designated committee* is used to approve *rating systems*, the *governing body* must be able to demonstrate adequate oversight of the decisions taken by the *designated committee.***
 - (3) **The *firm's governing body* or *designated committee* (where one is used) should have a continuing understanding of:**
 - (a) **the level of materiality of the *rating system* to the *firm* and its *group*;**
 - (b) **the key committee structure and authority levels within the *firm* and its *group* for approving *rating systems* and models, and material changes to them;**
 - (c) **the process for ensuring appropriate consistency between *rating systems* within the *firm*, and its *group*;**
 - (d) **for a *rating system* that is material to the operations of the *firm* or its *group*, the nature of the *rating system* itself, including:**
 - (i) **the products and customer segments covered by it;**
 - (ii) **at a high level, the *rating system's* key strengths and weaknesses;**
 - (iii) **at a high level, the relative roles of models and expert judgement in assigning ratings and estimating *PD*, and own estimates of *LGD* and *conversion factors*;**
 - (iv) **at a high level, the extent to which ratings may be overridden;**
 - (v) **the key qualitative and quantitative factors used as part of the *rating system* validation required under *BIPRU 4.3.25G-BIPRU 4.3.29G* and *BIPRU 4.3.31G* that are included in management reporting to the *governing body* or *designated committee* on the performance of the *rating system*;**

¹ This aspect of the copied-out *BIPRU* text is materially unchanged by the recent CRD amendments.

- (vi) **the process for ensuring the adequacy of performance of the *rating system*;**
- (vii) **a high-level understanding of the way in which the *firm's* use of the *rating system* meets the requirements of *BIPRU 4.2.2G* and *BIPRU 4.2.6G-BIPRU 4.2.7G*; and**
- (viii) **(if it is using a model) the basis of the *firm's* confidence that the data used to build the model meet the requirements of *BIPRU 4.3.44G(4)-(5)*.**
- (e) **the overall results of the stress testing required under *BIPRU 4.3.33G-BIPRU 4.3.34G*;**
- (f) **the roles and responsibilities of the credit risk control unit, the risk management function of the *firm* and its *group*, internal audit, and external auditors and other third parties in relation to the design, maintenance and validation of *rating systems*;**
- (g) **the nature and overall output of the *firm's* self-assessment to determine the extent of compliance with *BIPRU 4*;**
- (h) **where areas of material non-compliance have been identified under (f), the *firm's* action plan for achieving compliance with *BIPRU 4*; and**
- (i) **the key areas for priority review by internal audit during the coming year.**

APPENDIX 2: draft additional guidance on *good understanding* of senior management

7. Currently, the *BIPRU* text in this area is as follows²:

4.3.11G Senior management should have a good understanding of the *rating system's* design and operations. Senior management should ensure on an ongoing basis that the *rating systems* are operating properly. Senior management should be regularly informed by the credit risk control units about the performance of the rating process, areas needing improvement, and the status of efforts to improve previously identified deficiencies.

Proposed additional guidance

- 4.3.XG
- (1) **This paragraph provides *guidance* on *BIPRU* 4.3.11G.**
 - (2) **As part of the requirement for a good understanding of the *rating system's* design and operations, the *firm's* senior management should meet the requirements for a general understanding of the *firm's rating system* under *BIPRU* 4.3.XG.**
 - (3) **The depth of understanding required under *BIPRU* 4.3.11G will vary according to senior management's involvement with the *rating system* and its outputs.**
 - (4) **The following list provides examples of additional areas of understanding of material *rating systems* to which senior management should have regard:**
 - (a) **the number of grades or pools within the rating scale, the overall increase in risk between grades or pools and the extent of significant concentrations within particular grades or pools;**
 - (b) **the key material drivers identified of *PD* and where a firm is using its own estimates of *LGD* and *conversion factors* *LGDs* and *conversion factors*, and their limitations and on-going relevance;**
 - (c) **the overall level of ratings migration considered acceptable and the rationale for this;**
 - (d) **the overall extent of deviation from expectations in realised *PDs*, *LGDs*, *conversion factors* and, where *EL* is used, total losses;**
 - (e) **the arrangements for ensuring that the validation procedures used by the *firm* remain appropriate over time;**
 - (f) **the overall status of the work of the credit risk control units to measure, monitor, control and validate the performance of the rating system;**
 - (g) **the key assumptions and process for that stress testing the *firm* has undertaken in order to satisfy *BIPRU* 4.3.33G-*BIPRU* 4.3.34G;**

² This aspect of the copied-out *BIPRU* text is materially unchanged by the recent CRD amendments.

- (h) **an overview of the way in which the *rating system* meets the requirements of *BIPRU 4.2.2G* and *BIPRU 4.2.6G-BIPRU 4.2.7G*;**
 - (i) **(where a model is used) an overview of the completeness, accuracy and appropriateness of the data used to build the model; and**
- (5) **Senior management within the risk function of the *firm* and of its *group* should also have regard to the overall discriminative power of the *rating system*, including:**
- (i) **the types of qualitative and quantitative techniques used to measure discriminative power; and**
 - (ii) **material limitations of the techniques used.**