



Committee  
of European  
Banking  
Supervisors

# Electronic Guidebook



# Electronic Guidebook (EGB)

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# I. Introduction

## *Paragraph 1*

### **General**

1. During the first years of its existence, CEBS worked on several issues and published the final versions of guidelines on a diversity of subjects. The guidelines were released when ready, in order to allow the industry and supervisors time to take them into account in the implementation process of amongst others the CRD (the Directives 2006/48/EC and 2006/49/EC).
2. As the majority of this work has been finalised, and the industry and supervisors have moved from the development to the implementation phase, CEBS now presents the electronic guidebook of its work as set out in the 2006 and 2007 Work programmes.
3. The purpose of the Guidebook is to promote the consistent implementation of EU legislation and convergence of supervisory practices by compiling a compendium of the guidelines presented of CEBS. This electronic guidebook is intended to aid supervisors and market participants.
4. The EGB, including the separate chapter that compiles current Internal Governance ('IG') guidance, does not change the substance of the existing CEBS guidelines. It merely presents these guidelines in a different, more structured and more easily accessible manner.
5. This Guidebook presents the only up to date version of the CEBS guidelines. The various source documents which are separately published in the 'archive' or 'consultation' sections of the CEBS website have all been replaced by this guidebook. The archive and consultation sections show how this current overview came into being.
6. At the introduction of the Guidebook, the opportunity was taken to update references to the CRD as well as references to other parts of CEBS work which were not yet finalized when some of the work of CEBS was initially published. In line with CEBS' (amended) consultation practices, following a discussion with the Consultative Panel, it was decided that this did not necessitate a consultation. However, a version highlighting the technical adjustments made within this Guidebook has been published in the 'archive'.

### **Practical**

7. The Guidebook will have a flexible, internet-based structure that can be updated with ease. It will promote consistent terminology and definitions and may be viewed as a common layer of EU technical guidance. Upon the request of the industry, it was decided not to use the introduction of the Guidebook for harmonisation of e.g. terminology, as this would add additional checks into the current

implementation process. In the near future, no such harmonisation will take place, though the Guidebook will in due course no doubt be further harmonized by the partial updates necessary to keep the CEBS work up to date.

8. The guidebook is intended to be a flexible, internet based structure. Paper hardcopies are not envisaged. All the documents would be stored in a central database which allows flexibility. The main publication is on the public website of CEBS, with copies on cd-rom available if requested by the users. This is intended to facilitate the provision of information in various settings.
9. In CEBS' published 2007 work programme, it was intended to create a central chapter on internal governance, emphasising the key role that internal governance by the institutions plays in the ongoing supervision by CEBS members. As indicated above, this would lead to limited changes in text-structures and terminology. However, for transparency and ease of access, a separate pure compilation (extract) of the relevant guidelines on internal governance has been included in an annex. Please see paragraph 2 of this introduction for further details.
10. The term guidebook emphasises that CEBS work does not constitute rules as such but guidance and/or advice.
11. The guidebook aims to provide:
  - a) an instrument to enhance the consistent use of terms and definitions;
  - b) a full package of European banking guidance at level 3, with references to relevant work at level 1 and 2, and from other bodies;
  - c) approachable for full presentations as well as for subject-, industry-perspective and supervisor-perspective presentations;
  - d) links (also within the guidebook) are included to e.g. the relevant definitions and to relevant other documents or websites;
  - e) a plug-and-play modular approach as far as possible, in which gradually, as items become prioritised, new work can be inserted.
12. For questions on the guidebook or to request a copy on a cd-rom of the current version, please send a mail to [[guidebook@c-eps.org](mailto:guidebook@c-eps.org)].

## Paragraph 2:

### Internal Governance Overview

#### Introduction and definition

1. Over the years, increasing emphasis has been placed by international bodies on governance and internal control as key factors for the sound and prudent functioning of enterprises in an open-market economy<sup>1</sup> and for the economy as a whole. The importance of these issues, in particular for credit institutions and investment undertakings, is also reflected by the fact that both CEBS and the Basel Committee on Banking Supervision ('BCBS') have recently stressed the need for enhanced governance and issued guidance in this respect<sup>2</sup>.
2. Internal governance for credit institutions and investment undertakings can be described as a set of guidelines that is concerned mainly with setting an institution's business objectives and risk appetite and with determining how its business is organised, how responsibilities and authority are allocated, how reporting lines are set up and what information they convey, and how internal control (including risk control, compliance and internal audit) is organized.
3. Internal Governance (IG) is a separate, but crucial component of corporate governance, which covers, all aspects of both internal structure and relationships with all stakeholders in corporate life.

#### Overview and the approach taken

4. Solid and appropriate IG applies to the entire management of a company and entails setting objectives and developing a suitable organization for the company as a whole and for all its risks. The basis for this global vision of IG is to be found in Articles 22 and 123 of [Directive 2006/48/EC](#) (and Article 34 of [Directive 2006/49/EC](#) for investment firms). For the consolidated aspects of IG, reference is made for instance to Article 71 and Article 73, paragraph 3, of Directive 2006/48/EC. The two Directives taken together are referred to as the CRD<sup>3</sup>.
5. During the first years of its existence, CEBS issued various guidelines intended primarily to provide guidance for the implementation of the new capital accord (Basel II) as laid down in the CRD. Except for the guidelines on the supervisory review process, which encompass a

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<sup>1</sup> See for example the OECD Principles of Corporate Governance revised in April 2004.

<sup>2</sup> BCBS guidance "Enhancing corporate governance for banking organizations" of February 2006, and CEBS guidelines on the supervisory review process and on validation of advanced risk management approaches.

<sup>3</sup> Directive 2006/48/EC ([http://eur-lex.europa.eu/LexUriServ/site/en/oj/2006/l\\_177/l\\_17720060630en00010200.pdf](http://eur-lex.europa.eu/LexUriServ/site/en/oj/2006/l_177/l_17720060630en00010200.pdf)) of the European Parliament and of the Council of 14 June 2006 relating to the taking up and pursuit of the business of credit institutions and Directive 2006/49/EC of the European Parliament and of the Council of 14 June 2006 on the capital adequacy of investment firms and credit institutions.

general vision of good governance, the other guidelines relate to specific aspects of business management, and therefore their IG component is likewise relevant only to these aspects.

6. In some of the documents, there is explicit reference to the principles of IG (the guidelines on the supervisory review process and the guidelines on model validation and on the validation of advanced risk management approaches), while in others it is more implicit. Nonetheless there is clear reference to the responsibility of the institution and of its various bodies to provide appropriate guidelines for stress testing and outsourcing, among other things.
7. CEBS various guidelines on the different aspects of IG, have been inspired by existing documents and by international (prudential) fora, especially by the Basel Committee document mentioned above. It comprises a most relevant and comprehensive overview of the prudential expectations of supervisory authorities with respect to the IG of institutions. CEBS considers this paper acts as the main reference for its guidance on IG issues.
8. Against this background and in order to gain a sense of the whole range of IG provisions issued by CEBS, the IG provisions contained in the different CEBS documents (including in the guidelines on outsourcing, the guidelines on the supervisory review process, the guidelines on model validation, the guidelines on stress testing and concentration risk) have been gathered in the electronic guidebook and integrated into the structure of the guidelines on the supervisory review process. The excerpts have been reproduced unaltered. The resulting text – found in an appendix to the guidebook and named IG-compilation - provides an overview of the various provisions relevant to IG and emphasizes their interrelationship, without issuing any new or supplementary guidelines. The various CEBS guidelines regarding IG constitute part of a comprehensive framework for good governance that will serve as a basis for an overall assessment of a sound and prudent management of the institution.
9. The compilation of IG guidelines is structured around four topics:
  - a. Corporate Structure and Organisation: recommendations for a transparent corporate structure, with clearly delineated responsibilities, which encourages prudent management and facilitates the management of the institution's risks as determined by the institution's various bodies.
  - b. CEBS is also of the opinion that the recommendations of the Basel Committee for operating in jurisdictions or through structures that impede transparency, and the 'know your structure' recommendations (see principle 8 of the Basel paper), are very important in the context of supervising activities based in offshore financial centres.
  - c. Role and responsibilities of the management body: the management body is responsible for determining the strategy, business objectives and the institution's risk profile, and for developing a policy and organization that is capable of implementing it. Company strategy has to be communicated clearly throughout the organization.

Furthermore, the management body is responsible for making sure that strong internal control systems are in place.

- d. Internal Control: recommendations concerning the need for implementing effective internal control systems and for making available the instruments necessary for the purpose, in particular the independent control functions (internal audit, compliance and risk control function).
- e. Public disclosure and transparency: recommendations concerning disclosure and transparency in the interests of market discipline, which allows stakeholders to assess the quality of governance and the health of the financial institution.

10. Aspects of IG on which neither the BCBS nor CEBS has issued any specific recommendations would also benefit from drawing on generally accepted recommendations of (other) international *fora*. For example, on business continuity management, reference can be made to the recommendations developed by the Joint Forum on the subject for the entire financial sector<sup>4</sup>.

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<sup>4</sup> See the Joint Forum High-level Principles on Business Continuity (<http://www.bis.org/publ/joint17.pdf>) (August 2006).



## II. Committee of European Banking Supervisors

### CEBS role and task

In the banking sector as in other areas, the responsibility for transposing EU legislation into national law rests with the Member States. The Commission monitors national implementation of EU legislation and ensures that Community rules are properly applied. However, competent national authorities retain primary responsibility for determining how EU legislation is applied in practice: i.e., in taking supervisory decisions and setting supervisory procedures. The role of CEBS in this framework is to promote convergence of supervisory practices and to foster co-operation and information-sharing between national supervisors.

CEBS is composed of high-level representatives from the banking supervisory authorities and central banks of the European Union, including the European Central Bank. Twenty-seven member countries and 46 member organisations are represented on the Committee. Iceland, Liechtenstein and Norway participate in the Committee's work as observers. The European Commission and the Banking Supervision Committee of the European System of Central Banks (ESCB) also participate as observers. CEBS is supported by its Secretariat and several expert groups.

The declared aim of EU government leaders is to make Europe "the most competitive and dynamic knowledge-based economy in the world, capable of sustainable economic growth with more and better jobs and greater social cohesion." This overall strategy has been translated into a number of specific targets in different policy areas. CEBS' role in this process is to contribute to the stability of the European financial sector by providing sound technical advice based on best banking, supervisory, and market practices and by promoting consistent implementation of EU legislation as well as convergence in supervisory practices.

The precise role of CEBS is defined in the Commission Decision of 5 November 2003 Establishing the Committee of European Banking Supervisors ([2004/5/EC](#)). According to this Decision, CEBS has three main tasks:

- (1) to advise the Commission either at the Commission's request, within a time limit which the Commission may lay down according to the urgency of the matter, or on the Committee's own initiative, in particular as regards the preparation of draft implementing measures in the field of banking activities;
- (2) to contribute to the consistent application and implementation of Community directives and to the convergence of Member States' supervisory practices throughout the Community; and

(3) to enhance supervisory co-operation and the exchange of information between national supervisors, including the exchange of information concerning individual supervised institutions.

CEBS is building a framework that will help to ensure consistent implementation and application of EU legislation. CEBS is also promoting co-operation and convergence of supervisory practices in the EU. Finally, CEBS is actively involved in advising the Commission on technical details of banking regulation. These activities support the broader aims of the EU and its single market in banking.

The benefits of convergence are not limited to large cross-border groups. Local institutions increasingly find themselves competing with branches and subsidiaries of cross-border institutions, and they too will benefit from convergence of supervisory practices.

CEBS will support the Commission's strategy on the Financial Services Action Plan (FSAP) and post-FSAP. CEBS will highlight constraints on convergence and will aim to flag emerging problems before they become acute. Regular reporting to the European Institutions by CEBS will enable policymakers to form a clear picture of developments in the area of banking supervision and regulation.

CEBS' work has focused initially on supervisory practices relating to capital adequacy. This work was begun before the new EU legislative framework for capital adequacy had been finalised. Most work streams were initiated while the Commission's proposals were still being refined, and the work streams have taken shape while the draft Capital Requirements Directive (CRD) has been progressing through the EU co-decision process.

CEBS plans to issue several documents for public consultation while this process continues. The final CEBS Guidelines may therefore have to be amended to reflect any changes in the Directive.

CEBS is committed to conducting its work in an open and transparent manner, and to satisfying both formal requirements and public expectations for accountability.

A central element in CEBS' procedures for ensuring accountability is the use of public consultations. Before providing advice to the Commission or taking measures on its own, CEBS consults as fully as possible with market participants, consumers and other end-users. Consultations are public, open to all interested parties, and carried out in a transparent manner. When providing advice on provisions that apply to investment firms as well as to credit institutions, CEBS consults – through its members – with all authorities that have competence for the supervision of investment firms and are not represented in the Committee.

CEBS prepares an annual report which it submits to the Commission and also sends to the European Parliament and the Council. CEBS also publishes its work programme on a yearly basis.

## CEBS institutional documents

### **2.1.1. Commission Decision of 5 November 2003 establishing the Committee of European Banking Supervisors (2004/5/EC)**

[http://eur-lex.europa.eu/LexUriServ/site/en/oj/2004/l\\_003/l\\_00320040107en00360037.pdf](http://eur-lex.europa.eu/LexUriServ/site/en/oj/2004/l_003/l_00320040107en00360037.pdf)<sup>5</sup>

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<sup>5</sup> As to the history of the document, this Directive can be found on the CEBS website under the following link: <http://www.c-ebs.org/documents/about-us/about-us-intro-page/CommissionDecision.aspx>

**2.1.2. Directive 2005/1/EC of the European Parliament and of the Council of 9 of March 2005 amending Council Directives 73/239/EEC, 85/611/EEC, 91/675/EEC, 92/49/EEC and 93/6/EEC and Directives 94/19/EC, 98/78/EC, 2000/12/EC, 2001/34/EC, 2002/83/EC and 2002/87/EC in order to establish a new organisational structure for financial services committees**

[http://eur-lex.europa.eu/LexUriServ/site/en/oj/2005/l\\_079/l\\_07920050324en00090017.pdf](http://eur-lex.europa.eu/LexUriServ/site/en/oj/2005/l_079/l_07920050324en00090017.pdf) <sup>6</sup>

#### Lamfalussy Framework

The role of CEBS as an independent Level-3 committee is based on the framework proposed by the “Committee of Wise Men on the Regulation of European Securities Markets” chaired by Baron Alexandre Lamfalussy. The Committee of Wise Men was set up by the Economic and Finance Ministers of the EU (ECOFIN) in July 2000, with a mandate to assess current conditions for the implementation of the regulation of securities markets in the EU and to propose scenarios for adapting current practices in order to ensure greater convergence and co-operation in day-to-day implementation of EU-wide regulation.

The “Final Report of the Committee of Wise Men on the Regulation of European Securities Markets”, commonly referred to as the “Lamfalussy report”, was published on 17 February 2001. The report identified several shortcomings in the existing system for adopting legislation relating to securities regulation. The system was found to be too slow and too rigid, it tended to produce ambiguous legal texts, and it failed to distinguish between framework principles and practical day-to-day implementing rules. A number of regulatory reforms were proposed to address the shortcomings of the existing system.

These proposals were based on a new, four-level regulatory approach designed to make the decision-making procedures for securities market legislation faster and more flexible, while still ensuring the uniform application of Community law. This approach also envisaged the creation of

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<sup>6</sup> As to the history of this document, the Directive is on the CEBS website, under the following link: <http://www.cebs.org/documents/about-us/about-us-intro-page/Lamfalussy.aspx>

a new committee structure for regulation and supervision of securities markets.

The four-level approach consists of:

- Level 1 for the framework principles of community legislation, within which the Council and the European Parliament – acting on a proposal from the Commission – agree on the key political orientation on each subject;
- Level 2 for implementing measures i.e. the technical details of Community legislation which are adopted and changed via fast-track procedures, by means of a regulatory committee and on the basis of the advice of a committee of national supervisors;
- Level 3 for co-operation between national authorities and convergence of supervisory practices; and
- Level 4 for enforcement by the European Commission and Member States

The Lamfalussy report recommended increasing the use of regulations and fast-track Level 2 procedures wherever possible, enhancing supervisory and regulatory convergence, semi-annual monitoring of the effectiveness of the four-level regulatory procedure, and conducting a full and open review of the regulatory process in 2004. The Lamfalussy approach did not alter existing legal and advisory structures, but clarified the roles and responsibilities of the various players in order to provide better advice to the legislative authorities and promote more efficient co-operation among national authorities.

The Lamfalussy report was endorsed by the ECOFIN Council in March 2001. The Stockholm European Council, also in March 2001, welcomed the report and called for implementation of the proposed four-level approach “to make the regulatory process for European Union securities legislation more effective and transparent, thus improving the quality of the legislative measures proposed.” Full implementation of the Financial Services Action Plan was scheduled for 2005. In February 2002, the European Parliament agreed on the new approach for regulating European securities markets. An inter-institutional monitoring programme has been established to review the functioning of the new framework at regular intervals.

At an informal ECOFIN meeting in April 2002, it was agreed that work should continue in order to ensure that the EU would have appropriate structures in place for financial regulation and supervision in a rapidly-changing financial environment. The ECOFIN Council invited the EFC (Economic and Financial Committee) to assess possible arrangements for financial regulation and supervision. In its final report, the EFC’s recommendation was “to apply the Lamfalussy framework to all financial sectors with arrangements in line with those already implemented for securities, based on existing inter-institutional arrangements, whilst also recognizing sectoral specificities.” The EFC proposed the creation of three separate sectoral committees, for banking, insurance and securities, at

each of Levels 2 and 3. A fourth committee at Level 2 was proposed to deal with financial conglomerates that operate across sectors.

The ECOFIN Council endorsed the final EFC report in December 2002 and invited the Commission "to establish the level 2 committees in an advisory capacity only, and the level 3 committees as soon as possible". The level 3 committees were set up by Commission Decision of 5 November 2003.

The Directive establishing the new financial services committee structure was adopted in 9 March 2005, with the Banking Advisory Committee (BAC) being replaced by the European Banking Committee (EBC). The EBC is composed of high-level representatives of Member States; its chair and the secretariat are provided by the Commission. In order to ensure close co-operation with CEBS, the CEBS Chair is invited to participate at EBC meetings as an observer. In its advisory function, the EBC will be consulted by the Commission on policy issues relating to banking activities and on proposals in this field. The EBC will also assist the Commission in preparing mandates for technical advice by the CEBS on draft implementing measures.

## The main features of the Lamfalussy approach:

### **Level 1: Framework principles**

Level 1 is concerned with broad principles. Directives or Regulations are adopted using 'normal' legislative procedures. Proposals originate in the Commission, following consultation with all interested parties; and they are adopted under the 'co-decision' procedure by the Council and the European Parliament. The Level-1 process must also specify the nature and extent of the detailed technical implementing measures to be adopted at Level 2.

### **Level 2: Implementing Measures**

Level 2 is concerned with detailed technical measures. After consulting with the relevant Level-2 committee (for banking, the EBC – European Banking Committee), the European Commission requests advice from the Level-3 committee (CEBS). CEBS consults with market participants, end-users and consumers, prepares its advice and submits it to the Commission. The Commission reviews the advice and submits a proposal to the EBC. If a qualified majority of the EBC supports the proposal, the Commission enacts the proposal as legislation; otherwise the proposal is submitted to the Council in accordance with the standard regulatory procedure. The proposal passes unless there is a blocking (two-thirds) majority in the Council. The Parliament can issue a Resolution if it considers that the proposed measures are ultra vires. The EC Treaty<sup>1</sup> and the Council decision of 1999<sup>2</sup> do not grant any call-back right to the European Parliament, but the Commission has committed itself<sup>3</sup> to take the Parliament's position into utmost account.

### **Level 3: Co-operation and convergence**

In addition to their advisory function, Level 3 committees are charged with improving co-operation between supervisors and ensuring common and convergent implementation of level 1 and 2 legislation in the Member States. In pursuit of those goals, they develop joint interpretative recommendations, consistent guidelines and common standards; they undertake peer reviews; and they compare regulatory practices.

### **Level 4: Enforcement**

Level 4 aims at strengthened enforcement of Community law through more vigorous action by the Commission and enhanced co-operation between Member States, regulators and the private sector.

<sup>1</sup> [EC Treaty](#), Article 202, 1 February 2003.

<sup>2</sup> [Council decision 468/1999](#), Article 5, 28 June 1999.

<sup>3</sup> "Implementation of financial services legislation in the context of the Lamfalussy Report"-intervention by Romano Prodi President of the European Commission to the European Parliament's plenary session Strasbourg, 5 February 2002.

### 2.1.3. CEBS Charter<sup>7</sup>

#### **CHARTER OF THE COMMITTEE OF EUROPEAN BANKING SUPERVISORS (CEBS)**

**Having regard to:**

- 1) the mandate given by the ECOFIN Council to the Economic and Financial Committee to work on EU financial stability, supervision and integration (7 May 2002);
- 2) the reports of the Economic and Financial Committee on financial regulation, supervision and stability of 9 October 2002 and 28 November 2002;
- 3) the conclusions of the ECOFIN Council of 8 October 2002 and 3 December 2002;
- 4) the Report of the Committee on Economic and Monetary Affairs of the European Parliament and the Resolution of the European Parliament on prudential supervision in the European Union (6 November 2002 and 21 November 2002);
- 5) the Commission decision of 5 November 2003 establishing the Committee of European Banking Supervisors (2004/5/EC);
- 6) the proposal for a directive of the European Parliament and the Council amending European Parliament and Council Directive 2000/12/EC, Council Directive 91/675/EEC, Council Directive 85/611/EEC as last amended by European Parliament and Council Directives 2001/107/EC and 2001/108/EC, Directive 2002/87/EC, Directive 2002/83/EC, Directive 73/239/EEC (as amended by Directive 90/618/EEC), Directive 93/6/EEC, Directive 94/19/EC and establishing a new financial services committee organisational structure;

**considering** that the growth of efficient, competitive and sound banking markets, at the national, European and international levels, is necessary for the proper allocation of resources and the cost-effective financing of the economies of the Member States of the EEA;

**considering** the freedom of establishment and the freedom to provide financial services within the EEA;

**considering** the necessity to eliminate obstructive differences between the laws of the Member States, to make it easier to take up and pursue the business of credit institutions;

**considering** that the protection of savings and the creation of equal conditions of competition are fundamental to achieving and maintaining sound and stable financial markets;

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<sup>7</sup> As to the history of the document, the CEBS Charter can be found on the CEBS website under the following link: <http://www.c-ebs.org/aboutus/CEBS-charter.aspx>

**considering** that close co-operation as well as information exchange between regulatory authorities are essential for the successful supervision of the European banking sector and that synergies between banking supervision and central bank oversight should be taken into account, especially in the context of the Memorandum of Understanding on high-level principles of co-operation between the banking supervisors and central banks of the European Union in crisis management situations;

**having regard to** the importance of greater supervisory and regulatory convergence for the achievement of an integrated banking market in Europe;

**having regard to** the benefits of co-operation with other sectoral regulatory networks;

**having regard to** the need to base all its actions around a common conceptual framework of overarching principles for the regulation of the European banking market;

**having regard to** the importance of involving all market participants in the regulatory process and to work in an open and transparent manner;

**considering** that the role of the Committee of the European Banking Supervisors is to:

- (i) advise the Commission either at the Commission's request or on the Committee's own initiative, in particular for the preparation of draft implementing measures in the field of banking activities;
- (ii) contribute to a consistent implementation of EU directives and to the convergence of Member State's supervisory practises across the European Union;
- (iii) promote supervisory co-operation, including through the exchange of information;

the members of the Committee resolve to adhere, both in principle and in practice, to this Charter and to the following provisions:

## **ARTICLE 1 – MEMBERS OF THE COMMITTEE**

1.1 Each Member State of the European Union will designate a senior representative from the national competent supervisory authority in the banking field to participate in the meetings of the Committee. This representative will be the voting member. In addition, each Member State will designate as a non-voting member a senior representative of the national central bank when the national central bank is not the competent authority. In the case that the national central bank is the competent authority, the Member State may designate a second representative from this institution. The European Central Bank will also designate a senior representative as a non-voting member.

- 1.2 Applying the same rules as in 1.1, the competent supervisory authorities in the banking field from countries of the European Economic Area, which are not members of the European Union, will designate senior representatives to participate in the meetings as observers. These observers will fully participate in the meetings without, however, participating in decision making.
- 1.3 Upon signing of the Accession Treaty, observership will be granted to the acceding countries, until they become members of the European Union.
- 1.4 The European Commission as well as the Chairs of the Banking Supervision Committee of the ESCB (BSC) and of the Groupe de Contact (GdC) will also have observer status in the meetings. Where a common interest to work together appears, the Committee may accept additional observers to participate in meetings.
- 1.5 The members of the Committee should keep the national members of the European Banking Committee informed about its discussions and, where necessary, make all appropriate national arrangements to be in a position to speak for all competent national authorities that have an interest in the discussed matter.
- 1.6 Where relevant to its work, the Committee may invite external experts.

## **ARTICLE 2 – CHAIR**

- 2.1 The Committee will be chaired, in a personal capacity, by a voting member. The Chair will be chosen by consensus or – if consensus cannot be achieved – elected with a majority of two thirds of the voting members for a period of two years. In this respect, the voting members should seek to represent the common view of voting and non-voting members of the Member State. For the duration of the Chairmanship period, the relevant supervisory authority will nominate an additional member as representative.  
To assist the Chair, the Committee will also elect a Vice Chair among its voting members following the same procedure used to elect the Chair. The Vice Chair may replace and represent the Chair in case of absence or impediment.
- 2.2 The Chair organises and chairs the meeting of the Committee and executes all other functions delegated to the Chair by the Committee. The Chair is responsible for public relations and the representation of the Committee externally. The Chair is also responsible for the supervision of the Secretariat. After consultation with the Vice Chair, the Chair decides on the agenda of the meetings. The Chair may delegate some of its functions to the Vice Chair.
- 2.3 In addition to the Chair and Vice Chair and also for a period of two years, the Committee may elect up to three members to form the Bureau. These members shall reflect the composition of the

Committee. The role of the Bureau is to advise and assist the Chair, e.g. in the preparation of meetings and in its administrative functions and to monitor the budget in close co-operation with the Chair and the Vice Chair. Notwithstanding the above, the first Bureau will be elected for a period of three years.

### **ARTICLE 3 – OPERATIONAL LINKS WITH THE EUROPEAN COMMISSION**

- 3.1 The representative of the European Commission will be entitled to participate actively in all debates, except when the Committee discusses confidential matters.
- 3.2 Representatives from the European Commission will be invited to participate actively in meetings of Expert Groups, under the same conditions as in Article 3.1.

### **ARTICLE 4 – TASKS**

- 4.1 The Committee will advise the European Commission on banking policy issues, in particular in the preparation of draft measures for the implementation of European legislation (defined as “level 2 measures” in the Lamfalussy Report). The Committee may provide this advice either at the European Commission’s request or on its own initiative.
- 4.2 The Committee will respond within a time-limit, which the Commission may lay down according to the urgency of the matter, to the mandates given by the European Commission in respect of the preparation of implementing measures.
- 4.3 The Committee will foster and review common and uniform day to day implementation and consistent application of Community legislation. It may issue guidelines, recommendations and standards, relating to this and to other matters that the members will introduce in their regulatory/supervisory practices on a voluntary basis. It may also conduct surveys of regulatory/supervisory practices within the single market.
- 4.4 The Committee will develop effective operational network mechanisms to facilitate the exchange of information in normal times and at times of stress and to enhance day-to-day consistent supervision and enforcement in the Single banking Market.
- 4.5 The Committee will observe and assess the evolution of banking markets and the global tendencies in banking regulation in respect of their impact on the regulation of the Single Market for financial services. In this respect, the Committee will particularly take account of the work of the BSC.
- 4.6 The Committee will provide a platform for an exchange of supervisory information, in order to facilitate the performance of member’s tasks,

subject to the relevant confidentiality provisions stated in the EU legislation. In exceptional circumstances and at the explicit request of an individual member, those members, who represent the competent supervisory authority and further institutions which have a material operational and practical involvement in banking supervision (in principle, the institutions represented in the Groupe de Contact), may meet in restricted session in order to discuss strictly confidential micro-prudential matters, without prejudice to existing agreements for exchange of information. Banking supervisors of EEA member countries who are observers of the CEBS may also join a restricted session.

## **ARTICLE 5 – WORKING PROCEDURES**

- 5.1 The Committee will meet at least three times a year. Additional meetings may be convened if and when appropriate.
- 5.2 All decisions will be taken by the members of the Committee which may delegate decisions to the Chair.
- 5.3 In its working and/or deliberation and/or decisions, the Committee will respect the national and EU legislation regarding secrecy and confidentiality.
- 5.4 The Committee will rely predominantly on the Groupe de Contact, which will be its main working group and which will report to it. The Committee will endorse the Charter of the Groupe de Contact and its work programme.
- 5.5 In addition, the Committee may establish expert groups, chaired by a committee member (or under the member's supervision), working with a given mandate and to be disbanded upon completion of the mandated work. The composition of such expert groups should be flexible in order to involve other relevant authorities where necessary. The Committee may also establish permanent groups, working within specific terms of reference.
- 5.6 For the execution of its tasks as set out in Article 4 above, the Committee will aim to work by consensus of its members. Decisions are taken by consensus, unless when giving advice to the Commission. In that case, the Committee will strive for consensus, and, if no consensus can be reached, decisions will be taken by qualified majority, whereby each Member country has the same number of voting rights as in the Council as stated in the Nice Treaty. When a decision is taken by qualified majority, the Committee should identify and elaborate the opinion of individual members. With this aim, the different opinions of the members should be recorded.

Decisions taken by qualified majority are not legally binding in areas where national authorities are competent.

- 5.7 Unless otherwise stated, the principles under 5.6 will also apply in all remaining matters.
- 5.8 The Committee will ensure that in undertaking its work, it acts in conformity with the conceptual framework of overarching principles identified in the [ECOFIN Council Conclusions of 2002](#) and the [Commission Decision establishing the Committee](#).
- 5.9 The Committee will publish its annual work programme. Generally, the Committee may publish a summary of the non-confidential results of its meetings.
- 5.10 The Committee will use the appropriate processes to consult (both ex-ante and ex-post) market participants, consumers and end users which may include inter alia: concept releases, consultative papers, public hearings and roundtables, written and Internet consultations, public disclosure and summary of comments, national and/or European focused consultations. The Committee will make a public statement of its consultation practices and may establish a market participants consultative panel.

## **ARTICLE 6 – ACCOUNTABILITY AND INSTITUTIONAL LINKS**

- 6.1 The Committee will submit an Annual Report to the European Commission which will also be sent to the European Parliament and the Council.
- 6.2 The Chair of the Committee will report periodically to the European Parliament and/or when requested by the Council, and shall maintain strong links with the European Banking Committee.
- 6.3 The Chair of the Committee may participate as an observer in the meetings of other committees and groups, both at the European as well as at the international level, on request and when relevant for the work of the Committee. On behalf of the Committee, the Chair may address these committees with matters of common interest. The Chairs of the respective committees may also be invited to participate as observers in the Committee.
- 6.4 The Chair of the Committee shall aim to ensure adequate cooperation, e.g. by holding periodical meetings with the Chairs of the BSC, the CESR, the CEIOPS and of any other level 3 committee which will be established to discuss cross-sectoral issues of common interest.

## **ARTICLE 7 – SECRETARIAT**

- 7.1 The Secretary General shall be appointed by the Committee after being proposed by the Chair for a period of three years. The Chair shall propose the Secretary General after consultation with the Vice-Chair and the Bureau. This contract is renewable. Other permanent or seconded staff are appointed on a personal basis by the Chairman after consulting with the Vice Chair and the Secretary General.
- 7.2 In general, the seconded staff of the Secretariat will be provided by the voting members of the Committee; it will work under the responsibility of the Chair in close co-operation with the Vice-Chair. The Secretariat shall prepare and maintain the minutes of the meetings, assist the Committee and the expert groups in their functions and, finally, execute all other functions assigned to it by the Committee or the Chair.
- 7.3 The Secretariat will act as a co-ordinator for all consultations and assist the Chair and the Vice Chair in their public relations activities and representation functions; it will also coordinate the co-operation with the European Commission and other Level 3-committees.

#### **ARTICLE 8 – BUDGET**

- 8.1 The Committee will function with an annual budget. The Chair shall present, after consultation with the Vice-Chair and the Bureau, a proposal for this budget to the Committee no later than at the last meeting of the year preceding the budget year; the proposal has to be adopted by 31 December at the latest.
- 8.2 The members of the Committee and the observers mentioned in Article 1.2 will contribute annually to the budget. An internal rule will fix the amount of the annual individual contribution of each represented country, and the modalities of the payment. These contributions will be based on the number of votes held by the respective jurisdiction in Council meetings. If the country is not represented in the Council, contributions will be agreed on a proportional basis."

#### **ARTICLE 9 – FINAL PROVISIONS**

- 9.1 This Charter will take effect on 29 January 2004.
- 9.2 The Charter may be amended by consensus.
- 9.3 The Committee may adopt further rules to facilitate its functioning.

## Public Statements of Consultation Practices

*CEBS' main tools consist of standards and guidelines. Before delivering the results of its work CEBS is committed to conduct public consultations in an open and transparent manner.*

**Standards** are related to a legislative provision which per se is directly applicable, but whose application requires particular guidance for any other reason, or they are not directly related to Community legislation. Standards cover the substance as well as processes and can be addressed to supervised institutions as well as to supervisory authorities. For example, they may be used to explain to industry practitioners what supervisors will expect of them. They may also be addressed to national legislators in so far as some authorities have the power or need to incorporate them in national legislation.

**Guidelines** are further specification of EU legislation, especially where such legislation provides for minimum harmonization, covering the substance as well as processes. Guidelines will be addressed to supervised institutions and supervisory authorities. They may also be addressed to national legislators in so far as some authorities have the power or need to incorporate them in national legislation.

### 2.2.1 Public Statement of Consultation Practices<sup>8</sup>

The Committee of European Banking Supervisors was established on 1<sup>st</sup> January 2004 by a decision of the EU Commission (2004/5/EC). Its tasks include advising the Commission on banking regulation, promoting the consistent application of EU directives and the convergence of supervisory practices throughout the Community, and enhancing supervisory cooperation.

The Committee will consult extensively and in an open and transparent manner with market participants, consumers and end-users of banking services. The aims of consultation are to benefit from the expertise of market participants, consumers and end-users in identifying, assessing and analyzing regulatory issues and possible solutions, to promote understanding of the Committee's work and its role and, ultimately, to build consensus where possible between all interested and affected parties on what regulation or supervisory practice is appropriate.

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<sup>8</sup> How this text arrived to the current form please see: <http://www.c-eps.org/Publications/Consultation-Papers/CP01-CP10/CP01-Final-Paper.aspx> and the revised version published on 5 August 2008. <http://www.c-eps.org/Publications/Consultation-Papers/CP01-CP10/CP01-Final.aspx> (CEBS 2005 18) History/consultation

To deliver these aims, a flexible and proportionate approach to consultation that can be adapted according to the significance of an issue is required. The Committee's consultation practices are set out below.

### ***Who is consulted***

1. The Committee will generally:
  - i) target the full range of interested parties, including market participants (e.g. credit institutions, investment firms, etc), consumers and other end-users, as well as their representative associations;
  - ii) make consultation proposals, related documents and key dates for the consultation widely known and available through appropriate means, in particular the Internet; and
  - iii) consult at national, European and international levels.
2. When the Committee chooses to target its consultations at market participants and their representative associations only, in accordance with Article 11, such targeted consultations will always be announced in accordance with Article 1, ii). This will be followed by the publication of the Committee's final decision on the same topic.
3. The Committee will publish an annual work programme indicating whether a full or targeted consultation is intended on each area of anticipated work in accordance with Article 1, ii). If a request to be consulted on a particular area is subsequently received from another party, this request will be granted if it fits in with the time schedule set out in the work programme. The schedule of workstreams, indicating consultation periods, will be updated quarterly.

### ***Areas of consultation***

4. The Committee will consult on all its work in the area of advising the Commission on draft implementing measures for European legislation in the field of banking supervision (advice on level 2 issues).
5. The Committee will also consult on its work in providing guidelines, recommendations, standards and general advice and their related amendments (work on level 3 issues) in the area of:
  - i) the consistent application of Community directives;
  - ii) the convergence of Member States' supervisory practices;
  - iii) enhancing supervisory cooperation; and
  - iv) the overall structure of information exchange arrangements.

The development of guidelines, recommendations, standards and general advice (and their related amendments) will be subject to an impact assessment methodology, as approved by the Level 3 Committees. With amendments to existing Guidelines, the depth and intensity of the impact assessment methodology to be carried out (and

even whether it is needed) will be determined by the type of amendment.

6. The actual supervisory practices and actual exchanges of information, as ongoing work, will not be subject to consultation, for various reasons, including the issue of confidentiality.

### ***Modes of consultation***

7. The Committee will:

- i) provide an opportunity for interested parties to make submissions on receipt and publication by the Committee of a mandate from the European Commission;
- ii) produce reasoned consultative proposals, reflecting all relevant aspects of the issues at stake;
- iii) include in proposals preliminary information on their impact whenever available;
- iv) when necessary, release its thinking at various stages, including via the release of draft papers with initial questions or requests for comments in accordance with Article 1, ii), prior to a formal consultation period;
- v) establish consultative groups of technical experts if, prior to the formal consultation, informal discussions are planned (experts will be selected by the Committee and by the Consultative Panel); and
- vi) use a variety of means, including the Internet and written consultations, public hearings and roundtables (e.g. prior to a public consultation when needed), and, if necessary to deepen the Committee's understanding, bilateral meetings with affected parties.

### ***Timing of consultation***

8. The Committee will:

- i) publish any provisional or formal mandate received from the European Commission as soon as practical after receipt, in accordance with Article 1 ii);
- ii) organise upon request informal discussions at an early stage with those most likely to be directly affected;
- iii) consult in line with the cycles defined under Article 9 to enable the Committee to take the responses into account; and
- iv) provide the consulted parties with three months to respond in each formal consultation period.

9. CEBS will, unless article 11 is applicable, follow the following standard timelines:

*Standard Timeline for advice on level 2 issues:*

- 1) 4 months after receipt of the mandate for CEBS to draft a consultation paper, with possible informal meetings with technical experts recommended by the Panel;
- 2) 3 months public consultation;
- 3) 2 months for CEBS to analyze the comments received; and
- 4) 1 month for CEBS to prepare its final opinion and to submit it to the Commission.

If work is based on a provisional mandate or if it concerns a controversial matter, and it is possible within the given timescale, part 4 of this timeline will be replaced by a 1 month period for preparation of a new consultation document and:

- 5) 1 month for a second round of consultation; and
- 6) 3 months for CEBS to prepare a final opinion and submit it to the Commission.

*Standard Timeline for work on level 3 issues:*

- 1) Publication of the timeline for work on a level 3 issue.
- 2) preparation of a consultation paper, with possible informal meetings with technical experts recommended by the Panel;
- 3) 3 months public consultation;
- 4) 2 months for CEBS to analyze the comments received; and
- 5) 1 month for CEBS to prepare a feedback document and final opinion and to publish them.

If it concerns a controversial matter, and it is possible within the given timescale, part 5 of this timeline will be replaced by a 1 month period for preparation of a new consultation document and:

- 6) 1 month for a second round of consultation; and
- 7) 3 months for CEBS to analyze the comments received and to prepare the final document.

***Follow-up to consultations***

10. The Committee will:

- i) give due consideration to responses received;
- ii) make public in accordance with Article 1, ii) all responses to any of its ongoing or finalized consultations, unless the respondent requests otherwise;
- iii) publish a summary of the responses received and a reasoned explanation addressing all major points raised as feedback in the attached format, in accordance with Article 1, ii);
- iv) consult for a second time if the response to the first consultation reveals significant problems, or if revised

proposals are radically different from the original proposals on which the consultation was based; and

- v) publish all formal proposals and all advice given to the European Commission in accordance with Article 1, ii).

### ***Amendments to standard consultation procedures***

11. The Committee will as a rule apply the standard consultation procedure. Amendments may be made to the standard consultation procedure in the following circumstances:

- if the months of July and/or August or mid-December to mid-January are included in any standard period (either for technical work, for consultation or for feedback), the set term is lengthened by one month;
- if shorter timelines are set by third parties for work by CEBS;
- if there is no time constraint;
- if a provisional instead of a formal mandate is received;
- if it concerns technical advice or technical level 3 instruments with an impact only on a specific set of market participants;
- if the documents include information protected by e.g. secrecy regulations; or
- if guidelines, standards or recommendations previously submitted to a full consultation process are subject to drafting or limited amendments when the procedures in the annex will be followed.

### ***Final provisions***

12. If it is not possible for the Committee to follow the principles described above, the Committee will publicly explain its reasons.

13. When necessary, the Committee will review this statement of consultation practices.

### ***Annex: Procedures for amendments of guidelines, standards and recommendations***

1. All amendments to the CEBS guidelines, standards and recommendations will follow, as a general principle, the standard consultation process established with the standard timeline on Level 3 issues included in paragraph 9. Such amendments would include e.g. changes to a significant part of the CEBS guidelines, standards and recommendations or improvements in CEBS guidelines, standards and recommendations based on the experience of CEBS members in the practical application of these guidelines, where due to the relevance of the amendments, the need for a proper consultation process with external parties is more important than the need for a flexible process.

2. Based on current experience, possible exceptions to this general principle are:

- i) limited amendments: including e.g. amendments, additions or deletions to the guidelines, standards and recommendations that are deemed necessary to reflect technical changes in the underlying regulations (for example changes in the Guidelines on Financial Reporting due to changes in IAS/IFRS) or that just aim at précising or completing the existing guidelines (e.g. changes in the templates of the Guidelines on Supervisory Disclosure in order to increase the comparability among national implementations); and
- ii) drafting amendments (improvements): including e.g. correction of typos, deletion of duplications, additions to compensate for obvious omissions that do not change substantially the content of the Guidelines, corrections in references to external papers when those are changed and the like.

3. The decision on whether a proposed amendment can be considered limited or even a drafting amendment is a matter of judgment. The decision to depart from the standard consultation process will be taken by CEBS, after consultation with the Consultative Panel. The views of the Panel and the subsequent decision should take into account all anticipated amendments to a set of guidelines, standards, recommendations and general advice. This implies that the decision on the materiality of the amendment will be made by comparing the new suggested version of a CEBS guideline, standard, recommendation and general advice with the existing one.

4. Determination of the type of amendment decides the process to be followed in these cases.

5. The process for limited amendments is:

- a). CEBS will decide whether a contemplated amendment is limited (which would also impact on the depth and intensity of the necessary impact assessment methodology to be carried out);

- b). the proposed changes will be submitted for consultation to the Consultative Panel, with CEBS' views on the typology of amendment;
- c). contacts by CEBS experts at an early stage (before the consultation process), and during the consultation period, with representatives from the industry are encouraged in order to take a balanced view on the materiality of the proposed amendments;
- d). if the amendment is finally considered as limited, it will be submitted to a 1 month public consultation. Following the consultation, and after analysis of the comments received CEBS will prepare within 2 months the final amendments to the guidelines, standards, recommendations and general advice together with a feedback document. The foreseen periods would also take into account the circumstances included in paragraph 11, first bullet point; however
- e). a further revision may be necessary if, according to the responses received, it is finally concluded that the proposed amendments are a controversial matter. In such cases, CEBS will apply the provisions included in paragraph 9, sub-paragraphs 6-7.

6. The process for drafting amendments is:

- a) CEBS will decide whether a contemplated amendment is a drafting amendment only (which would also impact on the decision on the impact assessment methodology to be carried out);
- b) the proposed changes will be submitted for consultation to the Consultative Panel, with CEBS views on the typology of amendment;
- c) if the amendments are finally considered only to be drafting amendments, then the proposed amendments will be circulated to CEBS members who will have two-weeks to approve them (or make any objections known) in accordance with CEBS internal "red flag" procedure.

7. Amendments to guidelines, standards and recommendations will in all cases be documented as follows:

- a). a clean version will be posted on CEBS' public website;
- b). a link will be provided to documentation that identifies the amendments made to the guidelines, standards, recommendations and general advice.
- c). if there has been a public consultation, a feedback document will be available; it will summarize the comments received and

a reasoned explanation addressing the major points made in response; and

d).when CEBS has decided to follow the alternative process included in paragraphs 5 and 6, it will publish the reasons for the decision to do so as well as the views of the CEBS Consultative Panel, according to paragraph 12 of the document "Public statement of consultation practices"

8. Required changes to CEBS guidelines, standards and recommendations will only be made once a year in order to provide stable guidelines, standards and recommendations.



## III. Guidelines on Supervisory Processes

### Guidelines on Supervisory Disclosure<sup>9</sup>

#### Executive Summary

1. This paper sets out CEBS' guidelines for implementing a common European framework for supervisory disclosure. The framework is intended to make supervisory practices more transparent, which should in turn promote the legitimacy and credibility of supervisors from the perspective of the institutions that they supervise. This paper should therefore be of key interest to supervised institutions.
2. The need for transparency is all the more pressing in the context of increasing integration of European financial markets in Europe, which requires consistent implementation of EU legislation and convergence of supervisory practices. CEBS members recognise that supervisory disclosure promotes sound governance and is a powerful tool for convergence of supervisory practices across Europe.
3. The importance of supervisory transparency and accountability has been stressed by the Basel Committee on Banking Supervision and by the new European legislation<sup>10</sup>, which will require supervisors to make disclosures that permit meaningful comparisons of supervisory rules and practices across Europe.
4. The guidelines developed by CEBS implement a framework for supervisory disclosure at both the European and national levels.
5. The framework will make it easier to compare national texts that implement the [Capital Requirements Directive](#) (CRD), and to compare the ways in which Member States exercise the options and national discretions available to them in the CRD. In addition, the framework will enable institutions to compare the criteria and methodologies that supervisors use in evaluating and reviewing them. Finally, it will provide aggregate statistical data on key aspects of the implementation of the CRD.

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<sup>9</sup> As to the history of the document, please the following link on the CEBS website: <http://www.cebs.org/documents/Publications/Standards---Guidelines/files-from-old-website/GL05.aspx> .

<sup>10</sup> See the Capital Requirements Directive ('the CRD'), which replaced the Consolidated Banking Directive (2000/12/EC) and Capital Adequacy Directive (93/6/EEC), Article 144.

6. The scope of the framework has been limited to the provisions of the CRD that implement Basel II.
7. The form of disclosures plays an important role in allowing meaningful comparisons. The proposals set forth in this document seek to permit meaningful comparison in the following ways:
  - Disclosures will be accessible via the Internet, using both the CEBS website and national websites, which will be linked to each other.
  - CEBS recommends using a common format, consisting of a series of simple and similar information tables in standard formats which can be posted on websites. These tables have been designed to show two complementary levels of detail: summary tables on the CEBS website for ease of cross-country comparisons, linked to tables on the websites of national authorities that provide more detailed information.
8. CEBS has provided tentative templates for these tables. The templates are subject to change, to reflect developments in the CRD and in CEBS work streams.
9. A demonstration of the functionality of the framework is available on the CEBS website at [www.c-eps.org/Supervisory-Disclosure.aspx](http://www.c-eps.org/Supervisory-Disclosure.aspx).
10. The framework is written in English, the working language of CEBS. The information displayed on the CEBS website will be disclosed in English. Information on the national websites of non English-speaking countries will be available in English on a best-efforts basis. In any case, the information should be made available in national language prior to any translation.
11. The framework will be implemented by CEBS and the national authorities in charge of the supervision of credit institutions and investment firms by year-end 2006 as a target date for qualitative information, and by mid-2008 for the statistical data, recognising that some of the intended content may not yet be available at the time.
12. The CEBS draft guidelines went through a three-month public consultation and overall received a positive response. Attached to this paper is a feedback table which contains a summary of the key points arising from the consultation and the responses made to address them. It includes an annex reflecting CEBS' views on the detailed comments received. With regard to the internet mechanics of the framework, new functionalities have been added to reflect the comments made. The website demo has been amended accordingly (see. [www.c-eps.org/Supervisory-Disclosure.aspx](http://www.c-eps.org/Supervisory-Disclosure.aspx)).

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## SD Introduction

1. Transparency is a key element in effective banking supervision, as evidenced by its inclusion in Principle 1 of the [Core Principles on Effective Banking Supervision](#).<sup>11</sup> The effectiveness of supervision is closely related to the legitimacy and credibility of the competent supervisory authorities. Quite apart from any formal legal requirements, supervisors are accountable to governmental and parliamentary authorities, to the regulated industry, and to the general public for the conduct of supervision. They are accountable both for how they enforce compliance with prudential regulations and for how they foster sound governance practices on the part of the institutions<sup>12</sup> they oversee. Appropriate disclosure by supervisory authorities is desirable to ensure proper accountability, which in turn helps to promote sound governance practices on the part of the supervisors themselves.
2. Supervisory transparency and accountability are also stressed in the Basel Committee on Banking Supervision's ["Revised Framework for International Convergence of Capital Measurement and Capital Standards" \(Basel II\)](#), which notes: "the supervision of banks is not an exact science, and therefore, discretionary elements within the supervisory review process are inevitable. Supervisors must take care to carry out their obligations in a transparent and accountable manner."<sup>13</sup>
3. Structures that encourage transparency are all the more important, given that the new capital adequacy framework will introduce more complex rules that place greater reliance on the qualitative judgement of supervisors. This will increase the scope for supervisory discretion in a number of areas, at a time when the integration of the European banking market places a premium on supervisory convergence.

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<sup>11</sup> Principle 1 states that "an effective system of banking supervision will have clear responsibilities and objectives for each agency involved in the supervision of banks". This requirement is developed further in the Core Principles Methodology, the implementation guide used by the IMF and the World Bank in their joint Financial Sector Assessment Program (FSAP). The Core Principles Methodology states that supervisory agencies should set out their objectives, should be subject to regular review of their performance against their responsibilities and objectives through a transparent reporting and assessment process, and should ensure that information on the financial strength and performance of the industry under their jurisdiction is publicly available. (see Core Principles Methodology, "additional criteria" for assessing compliance with Core Principle 1 and also IMF Working Paper WP/02/163: "Crisis Prevention and Crisis Management: The Role of Regulatory Governance.")

<sup>12</sup> For the purpose of this paper, 'institutions' refers to both credit institutions and investment firms.

<sup>13</sup> See paragraph 779 of the Revised Framework for International Convergence of Capital Measurement and Capital Standards, June 2004. (<http://www.bis.org/publ/bcbs107.htm>)

4. European supervisory authorities recognise the importance of increased convergence in achieving an integrated banking market. They understand that supervisory disclosure will foster sound governance and promote convergence of supervisory practices across Europe.
5. The role of disclosure is specifically set forth in the Capital Requirements Directive ('the CRD'), which replaced the Consolidated Banking Directive (2000/12/EC) and Capital Adequacy Directive (93/6/EEC). In particular, Article 144 of the CRD provides that:

"1. Competent authorities shall disclose the following information:

- (a) the texts of laws, regulations, administrative rules and general guidance adopted in their Member State in the field of prudential regulation;
- (b) the manner of exercise of the options and discretions available in Community legislation;
- (c) the general criteria and methodologies they use in the review and evaluation referred to in Article 124 of [2006/48/EC](#);
- (d) without prejudice to the provisions laid down in Title V, Chapter 1, Section 2, of [2006/48/EC](#) aggregate statistical data on key aspects of the implementation of the prudential framework in each Member State.

The disclosures provided for in the first subparagraph shall be sufficient to enable a meaningful comparison of the approaches adopted by the competent authorities of the different Member States."

6. In addition, the other disclosure provisions in the CRD have been taken into account for the sake of consistency and completeness.<sup>14</sup>
7. What matters here is not so much the volume or the content of disclosure – national authorities already disclose a substantial amount of information – but rather the way in which disclosures are presented<sup>15</sup>.

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<sup>14</sup> See Annex I

<sup>15</sup> Article 150 of the CRD states that the Commission may adopt implementing measures using the Comitology procedure specifying the format, structure, contents list and annual publication date of the disclosures provided for in Article 144, and the key aspects on which aggregate statistical data are to be disclosed under Article 144 (1)(d).

8. The CRD's requirement that disclosures should be sufficient to enable a meaningful comparison of approaches provides an opportunity to develop a framework for disclosure that will ensure a certain degree of standardisation, notably in terms of language and of where the disclosures can be found. In this way, disclosures made by supervisors throughout Europe can be made more readily accessible and easier to compare.
9. The Commission and the BAC have asked CEBS to play a leading role in coordinating disclosures by national authorities and, in particular, to design a transparent and efficient common framework in the EU. The framework is constructed along the following lines:
10. The framework focuses primarily on the provisions of the CRD that relate to Basel II. However, in view of the fact that capital requirements are expressed in the form of a ratio, CEBS judged that failing to consider the numerator of the ratio could undermine the usefulness of the disclosures. The CRD's provisions concerning own funds<sup>16</sup> are therefore included in the framework as well. CEBS also recommends including the provisions of the CRD dealing with internal control mechanisms insofar as they relate to the Supervisory Review Process<sup>17</sup> and to Pillar 2 measures. In addition, the framework includes national provisions extending the requirements set forth in the Directive [2006/49/EEC](#) to investment firms, as well as provisions of Directive [2006/49/EEC](#) relating to capital requirements for market risks and to the definition and prudential treatment of the trading book.
11. The framework will be implemented by CEBS and the national authorities in charge of the prudential supervision of both investment firms and credit institutions. When investment firms are supervised by a different authority than the one that supervises credit institutions, coordination in implementing the framework will take place in the countries concerned.
12. It respects the following principles: a) it simply displays disclosures without interpreting nor validating them; b) it is not meant to limit the capacity of supervisors to act in a flexible and timely manner; and c) no individual decision regarding specific supervised institutions should be disclosed.
13. The framework is constructed in English. Non English-speaking countries will provide disclosures in English on a best-efforts basis, but in any case in their national language prior to any

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<sup>16</sup> Articles 56 to 67 of the Directive 2006/48/EC ([http://eur-lex.europa.eu/LexUriServ/site/en/oj/2006/l\\_177/l\\_17720060630en00010200.pdf](http://eur-lex.europa.eu/LexUriServ/site/en/oj/2006/l_177/l_17720060630en00010200.pdf))

<sup>17</sup> Article 22 and Annex V, Section V of the Directive 2006/48/EC ([http://eur-lex.europa.eu/LexUriServ/site/en/oj/2006/l\\_177/l\\_17720060630en00010200.pdf](http://eur-lex.europa.eu/LexUriServ/site/en/oj/2006/l_177/l_17720060630en00010200.pdf))

translation<sup>18</sup>. The framework aims at avoiding excessive administrative and translation burden. Its overall structure and format have been designed to be simple and flexible enough to be updated and adapted within a reasonable time schedule. It will be subject to regular monitoring by the CEBS Secretariat.

14. Disclosures will be accessible on the Internet, via the CEBS website and the national supervisory authorities' websites, interacting with each other. As common format, sets of simple tables in consistent formats<sup>19</sup> will be posted on the websites. Of course, the use of Internet will not preclude supervisors using alternative vehicles of disclosure.
15. This framework is the first step towards greater transparency on the part of supervisors. It is also an evolutionary process capable of adapting gradually to future changes in the rules, needs and practices of both supervisors and institutions.

## Transparency of supervision

### 1.1. Definition

16. Supervisory disclosure is defined as a comprehensive policy of transparency. Its aim is to make information related to prudential supervision available in a timely manner to all interested parties, including credit institutions, investment firms, other market participants, other supervisors, and consumers. The framework for supervisory disclosure is meant only to provide information. It is not meant to limit in any way the ability of individual national supervisors to act in a flexible, timely and independent manner, when required.

### 1.2. Objectives

17. The supervisory disclosure framework has two main goals:
  - *Enhancing the effectiveness of supervision*, by facilitating interaction between institutions and competent authorities; addressing the legitimate expectations of institutions, which need clarity and transparency of the rules they must comply with; and providing easy access to the disclosed information.
  - *Helping to promote a level-playing field throughout Europe*, by facilitating meaningful comparisons of supervisory approaches. Disclosure can be viewed as one tool among

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<sup>18</sup> CEBS has noted that in many countries only the texts in national language are deemed to have legal force.

<sup>19</sup> These tables are subject to changes following developments in the CRD and the CEBS work.

many for promoting convergence in supervisory practices across Europe.

18. In this respect, the disclosure framework will serve to enhance the transparency of the legislative and regulatory process in each Member State as it implements the CRD.
19. The primary users of the disclosure framework will be the supervised institutions, other market participants, and competent authorities. All of them should benefit from a more user-friendly framework that contributes to an improved exchange of information.
20. The framework is designed to satisfy the requirements of the CRD and to permit meaningful comparisons of the approaches adopted by national supervisors. Achieving these objectives calls for different approaches to each of the sub-paragraphs of Article 144 of Directive 2006/48/EC. Specifically:
  21. When disclosing the texts of laws, regulations, administrative rules, and general guidance under Article 144(1)(a), the emphasis should be on providing the most exhaustive and up-to-date information.
  22. However, when disclosing the manner of exercise of the options and national discretions under Article 144(1)(b), enabling end-users to make quick and meaningful comparisons should be considered a more important objective than providing exhaustive information in a single location.
  23. The disclosure under Article 144(1)(c) of supervisory review criteria and methodologies referred to in Article 124 is viewed as a tool to help institutions understand broadly how competent authorities will assess the systems and procedures required by the CRD. It may also provide an incentive for institutions to improve their own risk-management systems and procedures.
  24. The disclosure of aggregate statistical data under Article 144(1)(d) is intended to provide general information on the national banking sectors as well as on the implementation process in each Member State. The disclosures should cover both Pillar 1 and Pillar 2, with aggregate data reported in comparable terms over time.

### **Basic principles**

25. The supervisory disclosure framework is based on the following set of principles:

- i. The framework must be neutral with regard to the legal framework of each Member State. It aims at simply recording and transmitting factual information, without seeking to interpret or validate the disclosures. Moreover, the framework must not conflict with the normal process of transposing European legislation into national laws or regulations, which does not rely exclusively on supervisory authorities, but is legally the responsibility of the Member States under the Treaties.
- ii. The members of CEBS recognise that making disclosures in a common language will facilitate meaningful comparisons between the approaches adopted by the competent authorities in different Member States. The framework is therefore constructed in English, the working language of CEBS. All the information displayed on the CEBS website - including short texts such as the executive summaries required under Article 144(1)(c) - will be in English. The texts and documents disclosed on national websites under the framework will be made available in English on a best-efforts basis by the non English-speaking countries. They should at a minimum make their national texts available in their own language prior to any translation, and, for the sake of clarity, should state whether their national texts and documents are also available in English. In countries where only the texts in national language are deemed to have legal force, a disclaimer may need to be added to national websites –if such disclaimers have not already been made- in order to avoid any unintended legal liability arising from the translation. CEBS has drafted a disclaimer for its own use which it will post on its website.
- iii. The need for disclosure does not override the confidentiality principle dealing with the exchange of information and professional secrecy. Consequently, no supervisory actions or decisions directed at specific institutions are to be disclosed. In particular, disclosures relating to the supervisory process under Article 144(1)(c) should exclude any supervisory measures directed at specific institutions, whether taken with respect to a single institution or to a group of institutions. Likewise, the aggregate statistical data referred to under Article 144(1)(d) shall be disclosed only insofar as institution-specific data cannot be derived from the aggregate data. However, any data that an institution would itself be required to disclose, e.g. under Pillar 3, can be considered by the competent authorities not to raise a confidentiality issue. Competent authorities retain sole responsibility for determining when information may not be disclosed because of a potential breach of confidentiality. This principle will be flagged in the framework by a specific waiver.

- iv. The supervisory disclosure should be resource-efficient and should avoid excessive burden on supervisors. Accordingly, the framework is based on currently available information and no additional reporting should be required on the part of supervisors or institutions. The overall structure and the format of the framework have been designed to be simple and flexible enough to be updated and adapted within a reasonable time schedule.
  - v. The disclosure framework will be regularly monitored by CEBS, through its Secretariat. An annual report will be provided to the European Commission with a view to helping the Commission assess whether the objective of 'meaningful comparison' as stated in Article 144 is achieved.
26. Flexibility will be needed in order to make these principles workable in practice. Flexibility in a technical sense will be provided by using IT systems and the Internet, which will enable the framework to be easily accessible and quickly updated. Flexibility will also be needed with respect to the detail and scope of disclosures. For example, the framework will need to provide clear scope for competent authorities in small jurisdictions to benefit from the proportionality principle. Finally, flexibility will be needed when dealing with confidentiality issues, such as those raised by differences in size between European banking systems.

## **Main features**

### **1.3. *Internet architecture and format of publication***

27. The framework should provide easy access to relevant information and enable a meaningful comparison of approaches across EU countries. The use of the Internet is seen as the most technically suitable and user-friendly means to achieve these goals.
28. A two-tiered architecture is proposed, in which:
- i. The CEBS website will serve as a centralised electronic repository. It will allow for quick and easy comparison of relevant information, and will provide links to the websites of the national supervisory authorities.
  - ii. The websites of national competent authorities will provide the exhaustive and detailed information required by the CRD.

29. This two-tiered architecture is intended to strike an appropriate balance between the objectives of easy comparability (at CEBS level) and exhaustiveness (at national level). For instance, regarding the disclosures under Article 144(1)(b), CEBS will post on its website only the information provided by the national authorities which is needed to permit meaningful comparisons of the ways in which options and national discretions are exercised in the different Member States. This basic information will then serve as a quick reference to the more detailed information available on national websites.
30. The two-tiered architecture should not undermine the ability of competent authorities to set or change their national transparency policies, since they will not be prevented from disclosing additional material, and will remain solely responsible for the information made available on their websites.
31. On the technical side, competent authorities will retain control over the design (the use of a logo, of certain colours, etc.) and technical organisation of their national websites, as long as the templates for information tables provided by CEBS are inserted into the supervisory disclosure section of their websites.
32. The two-tiered architecture appears to be technically feasible, with the interaction between the two levels consisting of hyperlinks between web pages. To avoid unnecessary duplication of work and to ease the burden of updating of information at both national and CEBS levels, CEBS recommends that links to the actual texts of documents from the CEBS website be used only on an exception basis.
33. To ensure the comparability of information provided by different countries represented in CEBS, a certain degree of standardisation is considered necessary. CEBS therefore recommends that it and national competent authorities incorporate similarly-structured web pages devoted to supervisory disclosure into their own websites, and that they use a common format for their information tables.
34. Thanks to electronic links between websites, webpages and tables, the end-user should find it easy to navigate on both CEBS website and national websites, from one table to another, from one webpage to another, from the CEBS website to the national websites and vice versa.

35. The use of similar web pages and common templates for information tables is viewed as an appropriate means of ensuring consistency, at CEBS and national levels, across the four areas of disclosure. It should facilitate the meaningful comparison of supervisory policies and practices while allowing for easy access to information.
36. The use of common templates is not meant to require any modifications to the existing disclosure systems of national authorities. The disclosure framework provides technical flexibility to use disclosures made at the national level in their current form. This can be accomplished either by setting up hyperlinks from the CEBS-formatted tables to the relevant national documents displayed on national websites, or by displaying the information, if short enough, directly in the tables. National authorities will be free to choose between these two methods. Finally, use of the CEBS' templates will not preclude national authorities from disclosing additional information.
37. The templates consist of a set of information tables, to be filled in with the information and documents required under Article 144(1). They are divided into four sections, corresponding to the four sub-paragraphs of Article 144(1). The templates are only tentative. They will be kept up to date to reflect the current version of the CRD and the outcome of the CEBS' work. The proposed templates are accessible by clicking here: [www.c-ebs.org/Supervisory-Disclosure.aspx](http://www.c-ebs.org/Supervisory-Disclosure.aspx).
38. At the current stage of development, the disclosures required under Article 144(1)(a), will be displayed in eight tables. (<http://www.c-ebs.org/Supervisory-Disclosure/Rules-and-guidance.aspx>).
39. Two tables have been designed for Article 144(1)(b): one for the list of options and national discretions, and the other for mutual recognition provisions. They will be accompanied by short explanatory notes on how to use them. (<http://www.c-ebs.org/Supervisory-Disclosure/Options-and-national-discretions.aspx>).
40. The disclosures required under Article 144(1)(c) will be collected in a single table. (<http://www.c-ebs.org/Supervisory-Disclosure/Supervisory-review.aspx>).
41. The disclosures referred to in Article 144(1)(d) will be displayed in five tables. They will include aggregate data on national banking sectors, credit risk, operational risk and market risk data

for Pillar 1 and data on supervisory actions and measures for Pillar 2. The aggregate statistical data will be provided by national authorities to CEBS and posted on the CEBS website. For the sake of clarity and simplicity, the national websites will disclose the same templates with the same information. (<http://www.c-ebs.org/Supervisory-Disclosure/Statistical-Data.aspx>).

42. Aggregate data will be stored on CEBS' computers, creating a database that can be used for statistical analysis. Users will be given the tools to analyse historical data.
43. It has not been considered necessary to specify a common structure or format for explanatory text or other relevant information that competent authorities may wish to release (e.g. FAQs). (<http://www.c-ebs.org/Supervisory-Disclosure/national-web-pages.aspx>).
44. The framework will also include a page for disclosing contact information. At a minimum, this should include contact information for the country's CEBS members, the CEBS Secretariat members and the communication officers of the competent authorities. The information should include at least the name of each person and his or her exact title and/or area of expertise. The framework will provide flexibility for entering additional information of the contact person (such as personal e-mail address, direct telephone and fax numbers) or general contact information (e.g., the organisation's or functional e-mail address and switchboard number). (<http://www.c-ebs.org/Supervisory-Disclosure/national-web-pages.aspx>).

#### **1.4. Content of disclosure**

45. The content follows the structure of Article 144 quoted above:
  - 'Rules and guidance' covers national laws and regulations in the field of prudential supervision and regulation,
  - 'Options and national discretions' refers to the information about how options and national discretions are exercised,
  - 'Supervisory review' deals with the general criteria and methodologies used by competent authorities in their supervisory review and evaluation process referred to in Article 124,
  - 'Statistical data' refers to statistical data on key aspects of the implementation of the prudential framework.

### **1.4.1. Rules and guidance**

|     |                                                                                                                                                                                                                                                     |
|-----|-----------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| 46. | Article 144(1)(a) of <a href="#">Directive 2006/48/EC</a> requires competent authorities to disclose the texts of laws, regulations, administrative rules and general guidance adopted in their Member State in the field of prudential regulation. |
|-----|-----------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|

47. The information tables related to 'rules and guidance' are accessible by clicking here:

<http://www.c-eps.org/Supervisory-Disclosure/Rules-and-guidance.aspx>.

48. The supervisory disclosure framework will display the texts of the laws, regulations, and administrative rules used by each Member State to transpose the Basel II-related provisions of the [Directives 2006/48/EC](#) and [2006/49/EC](#). Depending on how much of the EU legislation has already been transposed, these may take the form either of new legislative and regulatory texts adapting these Directives into national law, or existing legislative texts or regulations amended accordingly.

49. For the purpose of supervisory disclosure, the term 'administrative rules' is understood to refer to documents that instruct supervised institutions on how to fulfil legislative and regulatory requirements. The character and legal enforceability of administrative rules is likely to vary from one Member State to the next. Nevertheless, for the sake of clarity and simplicity, they are considered here as 'third-level' documents – as compared to texts of laws ('first level') and regulations ('second level'). This definition does not restrict the disclosure policies of competent authorities; they retain sole responsibility for deciding what types of documents (e.g. instructions, methodological notes, administrative notices) are appropriate to disclose under the generic heading of 'administrative rules.' The same holds true for 'general guidance'. In general, however, competent authorities should strive for the widest possible disclosure, regardless of what legal instruments they use.

50. The following paragraphs provide illustrations of what might be disclosed under 'general guidance':

1. *Explicit disclosure requirements laid down in the CRD.*<sup>20</sup>
  
51. Articles 81(4) and 97(4) of the Directive 2006/48/EC require competent authorities to publish an explanation of the recognition process for External Credit Assessment Institutions (ECAIs) and a list of eligible ECAIs.
  
52. To meet this requirement, competent authorities should disclose the methodologies or key questions they use to assess the eligibility of ECAIs. CEBS recommends that competent authorities disclose the application process, indicating whether eligibility is based on the decision of another EU Member State's competent authorities, or on direct recognition. In the latter case, the disclosure should indicate whether this is done by accepting applications, either from credit institutions or from the ECAIs themselves; or using both methods. Competent authorities will indicate the main market segments for which the ECAIs have been recognised: 'public finance', 'commercial entities' (including corporate and financial companies) and/or 'structured finance' (including securitisation positions).
  
53. The CRD does not require competent authorities to disclose the mapping process they use to assign an ECAI's credit assessments to the steps in a credit-quality assessment scale. However, since this mapping is a key element in understanding how supervisors use ECAIs, CEBS recommends that the results of the mapping should be disclosed for each eligible ECAI.
  
54. Article 87(5) requires competent authorities to publish guidance on how institutions should assign risk weights to specialised lending exposures under the Internal Ratings Based approaches. To comply with this requirement, competent authorities should publish the slotting criteria that supervised institutions are required to use for specialised lending exposures when they cannot satisfy the minimum requirements for estimating the probability of default.
  
55. Article 100 requires the publication of any specific treatment of securitisations subject to early amortisation provision of retail exposures referred to in Article 100(3) and (4) when it becomes part of the general approach of competent authorities.

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<sup>20</sup> See Annex 1.

56. To cover these requirements, CEBS proposes information tables that will be amended at a later stage to take into account the final version of the CRD and the outcome of CEBS' current work on ECAIs. (<http://www.c-eps.org/Supervisory-Disclosure/Rules-and-guidance.aspx>).
2. *Disclosures judged necessary to explain how the rules should be applied by supervised institutions.*
57. At this stage, this refers essentially to the disclosure of guidance dealing with the validation of the IRB and AMA approaches. The disclosures should include validation guidelines published by national authorities, whatever their form (e.g. detailed technical guidance, working documents, supervisory rules, informal documents, interpretations, circulars, responses to industry questions). General information on the supervisory approval process itself should also be disclosed, as this may provide end-users with useful practical information.
58. The CEBS Guidelines on Model Validation is also part of the disclosure framework.
59. The definitive template for information tables have been provided, taking into account the validation guidelines (<http://www.c-eps.org/Supervisory-Disclosure/Rules-and-guidance.aspx>).
3. *Additional information.*
60. CEBS is currently considering requiring the disclosure of certain lists as this will support convergence in practices. National competent authorities would have to release either the lists or the general criteria to identify those exposures. Disclosures would include a list of regional governments and local authorities risk-weighted like central governments, a list of public-sector entities risk-weighted like institutions, and a list of core market participants referred to in Annex VIII of the Directive 2006/48/EC. The exact format and content of those lists are still under consideration. The proposed templates will be amended to take the outcome of this work into account (<http://www.c-eps.org/Supervisory-Disclosure/Rules-and-guidance.aspx>).
61. General guidance could cover any other relevant explanatory information to which competent authorities may wish to draw the attention of end-users in order to provide a basic understanding of the new capital adequacy framework. This information might

take the form of frequently asked questions (FAQs) at the national level, relating for instance to the national texts of laws, regulations or administrative rules referred to above.

#### **1.4.2. Options and national discretions**

- |     |                                                                                                                                                                                                     |
|-----|-----------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| 62. | Article 144(1)(b) of the Directive 2006/48/EC requires competent authorities to disclose the manner in which they exercise the options and national discretions available in Community legislation. |
|-----|-----------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
63. The information tables are accessible by clicking here: <http://www.c-eps.org/Supervisory-Disclosure/Options-and-national-discretions.aspx>.
64. Since many of the policy decisions regarding options and national discretions will be implemented via regulation, subparagraphs (a) and (b) of Article 144(1) are likely to overlap. This duplication is considered acceptable and even desirable, since it highlights the different focus of the two subparagraphs. Subparagraph (a) is intended to present a given Member State's national texts as a cohesive whole. Subparagraph (b) focuses on the differences between the national banking legislations of different Member States. Such differences should be presented together in order to facilitate comparative analysis. Moreover, specific issues related to investment firms might require some minor adjustments in the future, so as to take into account their particularities, in accordance with Article 37 of the Directive 2006/49/EEC.
65. For the sake of clarity, a consistent terminology has been adopted. 'Option' refers to a situation in which competent authorities or Member States are given a choice on how to comply with a given provision, selecting from a range of alternatives set forth in Community legislation.<sup>21</sup> 'Discretion' or 'national discretion' refers to a situation in which competent authorities or Member States are given a choice as to whether to apply, or not to apply, a given provision.<sup>22</sup>

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<sup>21</sup> For example, national authorities have the *option*, in determining the risk weights for exposures to institutions, of using either the central government risk-weight based method or the credit assessment based method.

<sup>22</sup> For example, Member States may, at *national discretion*, impose sub-consolidation in cases where it is not required and, if they do so, they may set the conditions.

66. Special attention has been paid to discretions for which mutual recognition is specifically allowed by the CRD. They are disclosed under a separate table. (<http://www.c-eps.org/Supervisory-Disclosure/Options-and-national-discretions.aspx>).
67. As noted in section III of this paper, the supervisory disclosure framework specifically excludes supervisory actions or decisions directed at specific institutions. Consequently, options and discretions which are exercised with respect to individual institutions or to a given set of institutions, rather than being generally applicable, should not be disclosed under Article 144(1)(b). In particular, when Directives refer to the need for an institution to obtain a competent authority's approval or authorisation for various purposes, such authorisation or approval might be discretionary, but it does not constitute a national discretion in the sense described above.
68. Finally, not all options or national discretions that might fall within the scope of the framework and meet the above definition are necessarily of interest for supervisory disclosure purposes. In particular, some options or discretions are exercised not by competent authorities or Member States, but by the institutions themselves. Competent authorities are not required to make disclosures concerning options which they do not have the power to exercise.
69. As a result, 101 options and national discretions out of the ones included in the CRD<sup>23</sup> would be disclosed and also 18 discretions with the mutual recognition clause. This number shrunk, in accordance with the recommendation from CEBS to the Council Working Group in September 2004. Therefore, the tables designed by CEBS have been kept up to date to reflect the development of the CRD and the outcome of CEBS' work on convergence. (<http://www.c-eps.org/Supervisory-Disclosure/Options-and-national-discretions.aspx>).

### **1.4.3. Supervisory review**

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|---------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| 70. Article 144(1)(c) requires competent authorities to disclose the general criteria and methodologies they use in the review and evaluation referred to in Article 124 (the Supervisory Review and Evaluation Process). |
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<sup>23</sup> See the list posted on the CEBS website.

71. The Supervisory Review and Evaluation Process (SREP) is one element of the larger Supervisory Review Process, the other element being the Internal Capital Adequacy Assessment Process (ICAAP).
- The ICAAP is conducted by the *institution*. It is a comprehensive process including the management body and senior management oversight, monitoring, reporting and internal control reviews that institutions must have to identify and measure their risks, allowing them to ensure that adequate provision is made for holding internal capital in relation to their risk profile.<sup>24</sup>
  - The SREP is conducted by the *competent authority*. It is also a comprehensive process which supervisors use to review and evaluate the institution's exposure to risks, the adequacy and reliability of the institution's ICAAP, the adequacy of the institution's own funds and internal capital in relation to the assessment of its overall risk profile, to monitor ongoing compliance with standards laid down in the CRD and to identify any weakness or inadequacies and necessary prudential measures<sup>25</sup>.
72. The supervisory disclosure framework provides information both on minimum standards and requirements for ICAAP and on how competent authorities conduct their own SREPs starting with the ICAAP/SREP dialogue. In practice, minimum standards for ICAAPs will already have been disclosed under Article 144(1)(a). However, the disclosure of the same requirements under Article 144(1)(c) is considered useful, as it provides end-users with a different perspective. The rationale for this overlap is the fact that the competent authority's review and evaluation of the ICAAP is an integral part of the SREP.
73. The guidelines developed by CEBS in this area, have been organised into an overall structure that groups SREP topics under broad categories or stages. The objective was to identify the conceptual building blocks of supervisory activity that constitute the core of the SREP.

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<sup>24</sup> See paragraph 20 of CEBS CP03 posted on the CEBS website. For the sake of clarity, the references to CP03 will be retained until the final Guidelines on the '**Application of the Supervisory Review Process under Pillar 2**' are released by CEBS. Please note that CP03 is under a second round of public consultation which ends on 21 October 2005.

<sup>25</sup> See paragraph 28 of the CEBS CP03 posted on the CEBS website

74. Four categories have emerged as common to all competent authorities. While specific definitions or details may vary over time or from one national authority to the next, the basic themes remain similar.
75. The organisation of these categories, as presented below, is derived mainly from the CEBS Guidelines on the Application of the Supervisory Review Process under Pillar 2. It also reflects the work done on internal governance. Further it takes into account the principles set out in the CEBS Guidelines on Supervisory Cooperation for Cross-Border Banking and Investments Firms Groups (also known as the Home Host Guidelines).
76. This structure should be easy to revise in order to reflect any changes in guidelines that may be forthcoming from CEBS.
77. The four categories are the following:
- (i) Scope and classification (including proportionality)
  - (ii) Individual Risk Assessment
  - (iii) Review and Evaluation of ICAAP
  - (iv) Overall assessment and supervisory measures
78. Competent authorities will be required to disclose the criteria and methodologies used in the first three categories and for the overall assessments in the fourth category. The authorities may, on a voluntary basis, also disclose the policies that guide their decisions for taking supervisory measures (within the meaning of Article 136(1)) whenever their assessment of an institution identifies weaknesses or inadequacies that call for supervisory intervention. Such disclosures might include the publication of internal guidelines or other documents describing general supervisory practices. However, no disclosure will be required regarding decisions on individual institutions, to respect the confidentiality principle.
79. Standing above the four categories, an overarching column, 'Dialogue/Interaction', will be used to describe the close relationship between competent authority and institution during all four stages of the SREP, from scope and classification to overall assessment and supervisory measures. While they are presented as separate stages in the supervisory process, all four categories involve interaction between institutions and competent authorities, particularly for larger, more complex and

systemically important institutions. Moreover, in practice, all four stages of the SREP are closely intertwined.

80. Another overarching dimension is proportionality. Both the requirements for the ICAAP<sup>26</sup> and the frequency and intensity of supervisory review and evaluation of those requirements<sup>27</sup> should be proportional to the nature, scale, and complexity of the activities of the institution concerned. This proportionality aspect has been integrated into the first category for easy reference, but it is relevant to the other categories as well.
81. Disclosures relating to the SREP will employ the same two-tiered architecture described in section IV of this paper :
- Guidelines and explanatory notes posted on the CEBS website will provide an overall understanding of the general features to be implemented by national authorities under each category.
  - An executive summary written by each national authority, and posted on both its website and the CEBS website, will give an overview of how it implements its SREP. This summary may consist either of separate summaries for each of the categories or a single summary covering all four categories. The executive summary will also include supplementary information on any aspect of the general criteria and methodologies used in conducting the SREP that goes beyond the harmonised rules and regulations or converged supervisory practices in this area.
82. The organisation of topics in the various explanatory notes has been updated to reflect the CEBS Guidelines on the Supervisory Review Process and the CEBS Home Host Guidelines. The information table is accessible by clicking here: <http://www.cebs.org/Supervisory-Disclosure/Supervisory-review.aspx>.
83. At this stage of the CEBS' work, special attention has been given to the source material (the CRD Articles and the CEBS Guidelines on the Supervisory Review Process' sections that provide guidance to institutions on conducting SREPs). The supervisory disclosure framework will always take into account other CEBS works when they are finalised.

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<sup>26</sup> See Article 123 of the Directive 2006/48/EC ([http://eur-lex.europa.eu/LexUriServ/site/en/oj/2006/l\\_177/l\\_17720060630en00010200.pdf](http://eur-lex.europa.eu/LexUriServ/site/en/oj/2006/l_177/l_17720060630en00010200.pdf))

<sup>27</sup> See Article 124 of the Directive 2006/48/EC.

*(i) Information to be disclosed under the category 'Scope and classification' (including proportionality)*

84. The explanatory note will cover Articles 22, 68-73, 123 and 124 of the Directive 2006/48/EC and paragraphs 14 and 19 of CEBS Guidelines on the Supervisory Review Process (for scope of application). It also covers CEBS guidelines on home-host issues, which will deal with cross-border co-operation and information exchange in more detail. Finally, it covers the general principle of proportionality contained in the CEBS Guidelines on the Supervisory Review Process.
85. Disclosure under this heading should also include the general principles and methodologies used by competent authorities to classify institutions. The disclosure should cover both quantitative analysis and qualitative criteria. In addition, any criteria and methodology used to categorise an institution's overall impact on financial stability or other overall supervisory objectives should be disclosed.

*(ii) Information to be disclosed under the category 'Individual Risk Assessment'*

86. The explanatory note will cover amongst others the SREP Guidelines and the RAS Guidelines contained in the CEBS Guidelines on the Supervisory Review Process. Subject to proportionality, each supervisor should outline the criteria and methodologies used in individualised off-site supervision (as compared with the more automated, largely IT-based rating of banks under the category of 'classification'). The intensity and degree of scrutiny applied by a supervisor may vary widely, ranging from no individual assessment beyond the classification rating, to a highly complex and detailed process of risk profiling.

*(iii) Information to be disclosed under the category 'Review and Evaluation of ICAAP'*

87. The explanatory note cover the ICAAP and the Internal Governance Guidelines contained in CEBS Guidelines on the Supervisory Review Process. Competent authorities may disclose their policies on the frequency and intensity of supervision<sup>28</sup> for

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<sup>28</sup> In this context, supervision is understood as a broad approach including on-site inspections/on-site examinations by examiners (narrow approach) and any other supervisory contact on-site such as visits with risk management, management accounting, internal audit or any other unit of an institution

the purpose of reviewing and evaluating a bank's internal ICAAP. The intensity of the interaction between the competent authority and the institution is subject to proportionality, as are any guidelines or minimum requirements for the ICAAP that the competent authority may issue. In addition, competent authorities may consider disclosing internal guidance relating to their on-site review and evaluation of ICAAP, such as examination manuals and other relevant material.

*(iv) Information to be disclosed under the category 'Overall Assessment and supervisory measures'*

88. The explanatory note will cover the Supervisory Measures Guidelines contained in the CEBS Guidelines on the Supervisory Review Process. The overall assessment by the competent authority is based on a review of all the activities referred to under categories 1 through 3, along with any other relevant information about the institution that the competent authority may obtain. The form and level of detail of the assessment is, once again, subject to proportionality, particularly with respect to the individual risk profile as described in category 2.
89. Based on this overall assessment, each competent authority decides if supervisory measures are necessary and, if so, what measures are appropriate. As stated in paragraph 78 of this paper, policies that guide decisions on taking supervisory measures may be published by competent authorities.

**1.4.4. Statistical data**

|     |                                                                                                                                                                                                       |
|-----|-------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| 90. | Article 144(1)(d) of the <a href="#">Directive 2006/48/EC</a> requires competent authorities to disclose aggregate statistical data on key aspects of the implementation of the prudential framework. |
|-----|-------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|

91. The 'key aspects' should include information about banks and investment firms on both the supervisory process (e.g. the number of institutions supervised) and supervisory outcomes (e.g. tier-1 ratios or Pillar-1 credit-risk capital requirements). This information should cover both banks and investment firms.

92. Disclosures should have both a descriptive and a quantitative component. For the methodology used to define and calculate the aggregate statistical data, reference is made to Annex II which provides a list of definitions.

93. In principle, the aggregate statistical data will be based on information that is already available to the competent authority. The disclosures should therefore not involve any additional burden for the supervised institutions.
94. Possible sources of information include the CEBS Common Reporting framework for Pillar 1 data, internal data from competent authorities for Pillar 2 data, and Central Bank data (e.g. structural reports of the European Central Bank) for national data.
95. The table on national data presents key statistics for banks and investment firms on a domestic basis, together with key solvency data on a national consolidated basis. The other tables present more detailed risk data for each country, also on a national consolidated basis rather than a solo basis.
96. To facilitate comparison of the data in the tables, the key statistics are displayed in relative terms, using percentages, instead of using absolute values.
97. In principle, the aggregate data should cover 100 percent of the supervised institutions. Less than 100 percent coverage will be permitted only if the omitted data are not considered to be material. Data will be considered material if their omission or misstatement might influence the assessment of the user.
98. To address the issue of confidentiality, the following disclaimer will be posted on each of the tables (<http://www.cebs.org/Supervisory-Disclosure/Statistical-Data.aspx>) :

"No confidential information which competent authorities may receive in the course of their duties may be divulged to any person or authority whatsoever, except in summary or collective form, such that individual credit institutions cannot be identified, without prejudice to cases covered by criminal law.<sup>29</sup> Accordingly, whenever the disclosure of aggregate statistical data would result in a breach of confidentiality as determined by the national competent authority, those data should not be disclosed."

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<sup>29</sup> The first sentence of the disclaimer is taken directly from Article 44(1) of the Directive 2006/48/EC ([http://eur-lex.europa.eu/LexUriServ/site/en/oj/2006/l\\_177/l\\_17720060630en00010200.pdf](http://eur-lex.europa.eu/LexUriServ/site/en/oj/2006/l_177/l_17720060630en00010200.pdf)).

99. If data are not being disclosed, the reason for non-disclosure will be mentioned for that 'blank' cell. More specifically, an index will be used that specifies whether the data for that cell are not available (N/A), confidential (C) or not material (N/M).
100. With respect to the Pillar 2 data which will be provided on a country-by-country basis, it should be stressed that, due to differences in national regulations as well as in supervisory practices and approaches across Member States, the figures provided might not be fully comparable, and before drawing any conclusions, these differences should be carefully considered.

### **1.5. Implementation and updating**

101. The Supervisory Disclosure Framework consistent with the present guidelines is expected to be implemented gradually, for several reasons.
102. First, some of the information required (e.g. laws and regulations transposing the Directives into national legislation) was not available before the CRD has been definitively adopted. Second, Member States will probably disclose gradually how they implement their Supervisory Review Process. Third, aggregate statistical data will be available only at year end. Finally, translation burden may delay the whole process, even if competent authorities commit to disclose information in English on a best-efforts basis and in a timely manner.
103. Nevertheless, in view of the legitimate interest of end-users in having disclosures available as early as possible, year-end 2006 is set as a target date with respect to paragraphs (1)(a) through (1)(c) of Article 144, and mid-2008 with respect to paragraph (1)(d).
104. In order to keep the disclosure framework up to date, competent authorities will update their disclosures at least once a year. Disclosures under Article 144(1)(a) through (1)(c) should be updated no later than the end of January of each year, while disclosures under Article 144(1)(d) should be updated by July to allow time for data processing and aggregation of the previous year's data.
105. The process used for updating the disclosure framework should respect the current disclosure practices of national competent authorities, since they remain responsible for the information they disclose. This would automatically be the case if full use is made of the two-tiered structure described in section IV of this paper. If the structure relies on hyperlinks between webpages, any updates made to a national website should automatically

result in updating the CEBS website. Should there be no automatic update, national authorities will be responsible for notifying CEBS when an update of information contained in the national part of the supervisory disclosure framework is made. Accordingly, the general principle should be that any national update triggers an update of the CEBS website.

106. In order to keep end-users informed of the status of the information disclosed, a list of updates will be displayed in the front page of each of the four current sections (Rules and Guidance, National Discretions and Options, Supervisory Review, and Statistical Data), in the following format (see also the CEBS website demo).

Latest updates

| Date      | Country                                                                  |
|-----------|--------------------------------------------------------------------------|
| 11.9.2006 | <u>Austria</u> (with a link to the updated page of the national website) |
| 18.9.2006 | <u>Belgium</u>                                                           |

107. An email alert system will allow users allow the user to be informed automatically each time a change has been made in the framework or in specific parts of the framework, depending on the various types of information requests that the user subscribes to (see the CEBS website demo).

## The review of the framework

108. In accordance with its Charter<sup>30</sup>, CEBS, through its Secretariat, will conduct an annual review of the implementation of the disclosure framework.
109. The CEBS Secretariat will carry out a fact-finding and stock taking exercise to monitor whether the required information is provided and disclosed.
110. CEBS is not responsible for the quality of the information provided by competent national authorities. The CEBS Secretariat's annual review will examine *only*:
- i. whether the tables have actually been filled in,
  - ii. whether the information has been updated,
  - iii. whether the information is disclosed in English and
  - iv. whether any technical problems arising from the use of hyperlinks on the CEBS website have been resolved on a best-efforts basis.
111. The CEBS Secretariat will then test its preliminary findings with the relevant competent authorities and come up with a final outcome.
112. The results of this review will be summarised in the annual report of CEBS and will be provided to the Commission for information. This should assist the European Commission to assess whether the framework effectively contributes to the objective of an on-going 'meaningful comparison of approaches' as stated in Article 144 of the [Directive 2006/48/EC](#).

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<sup>30</sup> Article 4.3 of its Charter, which states that "The Committee will foster and review common and uniform day to day implementation and consistent application of Community legislation." [...] It may also conduct surveys of regulatory/supervisory practices within the single market.

## **Annex I**

### **List of the articles related to supervisory disclosure**

#### Directive 2006/48/EC

Recital (61): "in order for the internal market in banking to operate with increasing effectiveness and for citizens of the Community to be afforded adequate levels of transparency, it is necessary that competent authorities disclose publicly and in a way which allows for meaningful comparison the manner in which this Directive is implemented."

#### Article 81.4

"Competent authorities shall make publicly available an explanation of the recognition process, and a list of eligible ECAs."

#### Article 87.5

"Notwithstanding paragraph 3, the calculation of risk weighted exposure amounts for credit risk for special lending exposures may be calculated in accordance with Annex VII, Part 1, paragraph 5. Competent authorities shall publish guidance on how institutions should assign risk weights to specialised lending exposures under Annex VII, Part 1, paragraph 5 and shall approve institutions assignment methodologies."

#### Article 97.4

"The competent authorities shall make publicly available an explanation of the recognition process and a list of eligible ECAs."

#### Article 100.4

"Where a competent authority intends to apply a treatment in accordance with paragraph 3 in respect of a particular securitisation, it shall first of all inform the relevant competent authorities of all the other Member States. Before the application of such a treatment becomes part of the general policy approach of the competent authority to securitisations containing early amortisation clauses of the type in question, the competent authority shall consult the relevant competent authorities of all the other member States and take into consideration the views expressed. The views expressed in such consultation and the treatment adopted shall be publicly disclosed by the competent authority in question."

#### Article 144

"1. Competent authorities shall disclose the following information:

- (a) the texts of laws, regulations, administrative rules and general guidance adopted in their Member State in the field of prudential regulation;
- (b) the manner of exercise of the options and discretions available in Community legislation;
- (c) the general criteria and methodologies they use in the review and evaluation referred to in article 124;
- (d) without prejudice to the provisions laid down in Title V, Chapter 1, Section 2, aggregate statistical data on key aspects of the implementation of the prudential framework in each Member State.

The disclosures provided for in the first subparagraph shall be sufficient to enable a meaningful comparison of the approaches adopted by the competent authorities of the different Member States. "

#### Article 150.2

"The Commission may adopt the following implementing measures in accordance with the procedure in Article 151:

- (d) specification of the key aspects on which aggregate statistical data are to be disclosed under Article 144 (1) (d)
- (e) specification of the format, structure, contents list and annual publication date of the disclosures provided for in Article 144.

#### ANNEX VIII – Credit risk mitigation, Part 1- Eligibility

##### 1. Funded credit protection, Real estate collateral

§ 16: "The competent authorities may waive the requirement for their credit institutions to comply with condition (b) in paragraph 13 for exposures secured by residential real estate property situated within the territory of that Member State, if the competent authorities have evidence that the relevant market is well-developed and long established with loss-rates which are sufficiently low to justify such action. (...) Member States shall disclose publicly the use they make of this waiver."

#### [Directive 2006/49/EC](#)

##### Recital no 30

“In order for the internal market to operate with increasing effectiveness and for citizens of the Community to be afforded adequate levels of transparency it is necessary that competent authorities disclose publicly and in a way which allows for meaningful comparison the manner in which the requirements of this Directive are implemented.”

## Annex II

### Preliminary definitions for calculating the 'statistical data' part of the supervisory disclosure framework

#### Definitions on data on the national banking sectors in the EU

1. *Number of credit institutions (CI):*

A credit institution is a company that meets the description, as laid down in Article 1 and 4 of [Directive 2006/48/EC](#). The figure includes domestically incorporated institutions, branches of the EEA as well as non-EEA credit institutions. Any number of places of business set up in the respective country by a credit institution with headquarters in another country, is counted as one credit institution. The definition includes branches / subsidiaries of foreign banks but not foreign branches / subsidiaries of domestic banks (host country approach).

2. *Total assets of CI*

Total assets of credit institutions. Non-consolidated data required. Calculated on a residential basis (host country approach, with a population that corresponds to the principles, as laid down under 1).

3. *Gross Domestic Product*

At market price (suggested source Eurostat/ECB).

4. *Number of branches of CI from EEA countries*

A branch is a place of business which forms a legally dependent part of a credit institution and which carries out directly all or some of the transactions inherent in the business of credit institutions. Any number of places of business set up in the same country by a credit institution with headquarters in another country should be counted as a single branch.

5. *Total assets of branches of CI from EEA countries*

The sum of the total assets of branches as defined in number 4.

6. *Number of subsidiaries of CI from EEA countries*

A subsidiary is a separate incorporated credit institution in which another (EEA) credit institution has a majority or full participation. Any subsidiary of a subsidiary undertaking shall be regarded as a subsidiary of the parent undertaking which is at the head of those undertakings.

7. *Total assets of subsidiaries of CI from EEA countries*

The sum of the total unconsolidated assets of the subsidiaries as defined in number 6.

8. Number of branches (see number 4) of CI from third countries

9. Total assets of branches (see number 5) of CI from third countries

10. Number of subsidiaries (see number 6) of CI from third countries

11. Total assets of subsidiaries (see number 7) of CI from third countries

12. *Total tier I capital*

Original own funds as composed by items (a), (b) and (c) of Article 57 of the [Directive 2000/48/EC](#), deducted by items (i), (j), (k) and by 50% of items (l) to (r) of Article 57 of the DIRECTIVE 2006/48/EC according to Article 66 paragraph 2 of this Directive.

13. *Total tier II capital*

Additional own funds as composed by items (d), (e), (f), (g) and (h) of Article 57 of the DIRECTIVE 2006/48/EC and deducted by 50 % of items (l) to (r) of Article 57 after application of the limits of Article 66 paragraph 1 according to Article 66 paragraph 2 of this Directive.

14. *Total capital*

The Tier I (see number 12) and Tier II (see number 13) capital plus ancillary own funds as defined in Articles 13-15 of the [Directive 2006/49/EC](#).

15. *Total risk weighted assets*

The total assets and off-balance sheet items, risk-adjusted in accordance with the Sections 3 and 4 of the Directive 2006/49/EC.

16. *Total capital adequacy ratio*

Total capital (see number 14) as a proportion of total risk weighted assets (see number 15) plus the calculated total of market risk positions (converted into risk weighted assets).

17. *Number of investment firms*

Firms that meet the investment firm definition of Article 4 of [Directive 2004/39/EC](#).

18 *Total assets of investment firms*

The total assets of investment firms. Non-consolidated data required. Calculated on a residential basis (host country approach, see number 1).

## Definitions on Credit Risk data

19. *Standardised Approach to credit risk*  
Standardised Approach for calculating the risk weighted exposure amount, as provided in Title V, Chapter 2, Section 3, Subsection 1, Articles 78-83 as well as Annex VI of the [Directive 2006/48/EC](#).
20. *Foundation IRB approach to credit risk*  
Internal Ratings Based Approach for calculating the risk weighted exposure amounts as provided in Section 3, Subsection 2, Articles 84-89 of the Directive 2006/48/EC based on values for LGDs and conversion factors, as provided in Section 3, Subsection 2, Article 87(8) of Directive 2006/48/EC.
21. *Advanced IRB*  
Internal Ratings Based Approach for calculating the risk weighted exposure amounts as provided in Section 3, Subsection 2, Articles-84-89 of the Directive 2006/48/EC based own estimates for LGDs and/or conversion factors as provided in Section 3, Subsection 2, Articles 87(7) and 87(9) of the Directive 2006/48/EC.
22. *Own funds requirements for credit risk*  
Total minimum level of own funds for credit risk as defined by Article 75 (a), Article 76, Annex VI and Annex VII of the Directive 2006/48/EC). The requirement calculation must also take into account a number of other elements in the directive.
23. *Total own funds requirements*  
Total minimum level of own funds as defined by Article 75 (a)-(d) of the Directive 2006/48/EC.
24. *Own funds requirements*  
For a particular approach, the minimum level of own funds for credit risk as defined by Title V, Chapter 2, Section 3, Articles 76-93, Annex VI and Annex VII of the Directive 2006/48/EC.
25. *Exposure*  
An asset or off-balance sheet item as defined by Article 77 of the Directive 2006/48/EC.
26. *Asset class*  
  
Asset classes are broadly defined to achieve the highest degree of commonality between the exposure classes as defined in Article 79(1) of the Directive 2006/48/EC for the Standardised Approach and Article 86(1) for the Internal Ratings Based approach.

The proposed definitions of asset classes below are indicative and subject to further review once the CEBS' work on the Common reporting framework is finalised.

All exposures are mapped onto 8 exposure classes. The 8 exposure classes are: Central Governments & Central banks, Institutions, Corporate, Retail, Equity, Securitisation positions, Other non-credit obligation assets, Other items.

27. *Central Governments & Central Banks*

Exposure class as defined by Article 86(1)(a) of the Directive 2006/48/EC for the Internal Ratings Based Approach. For the Standardised Approach, this exposure class includes the exposure classes defined in Article 79(1)(a)-(e).

28. *Institutions*

Exposure class as defined by Article 86(1)(b) of the Directive 2006/48/EC for the Internal Ratings Based Approach. For the Standardised Approach, this exposure class includes the exposure classes defined in Article 79(1)(f) and (1)(l).

29. *Corporate*

Exposure class as defined by Article 86(1)(c) of the Directive 2006/48/EC for the Internal Ratings Based Approach. For the Standardised Approach, this exposure class includes the exposure classes defined in Article 79(1)(g) and (1)(i), and Annex VI, Part I, point 9.2 Exposure secured by mortgages on commercial real estate.

30. *Retail*

Exposure class as defined by Article 86(1)(d) of the Directive 2006/48/EC for the Internal Ratings Based Approach. For the Standardised Approach, this exposure class includes the exposure classes defined in Article 79(1)(h) and (1)(i), and Annex VI, Part I, point 9.1 Exposure secured by mortgages on residential property.

31. *Equity*

Exposure class as defined by Article 86(1)(e) of the Directive 2006/48/EC for the Internal Ratings Based Approach. For the Standardised Approach, this exposure class includes the exposure classes defined in Article 79(1)(k) and (1)(o).

32. *Securitisation positions*

Exposure class as defined by Article 86(1)(f) of the Directive 2006/48/EC for the Internal Ratings Based Approach. For the Standardised Approach, this exposure class includes the exposure classes defined in Article 79(1)(m).

33. *Other non-credit obligation assets*

Exposure class as defined by Article 86(1)(g) of the Directive 2006/48/EC for the Internal Ratings Based Approach.

34. *Other items*

Exposure class as defined by Article 79(1)(j), (1)(n) and (1)(p) of the Directive 2006/48/EC for the Standardised Approach.

35. *Credit risk mitigation*

A technique used by a credit institution to reduce the credit risk associated with an exposure or exposures which the credit institution continues to hold, as defined in Article 4 (30) and Section 3, subsection 3, Articles 90-93 and Annex VIII of the Directive 2006/48/EC.

36. *Financial Collateral Simple Method*

Under this valuation method, recognised financial collateral as a credit risk mitigation technique is assigned a value equal to its market value. This method is only available where risk weighted exposure amounts are calculated under the Standardised Approach. See Annex VIII, part 3, paragraphs 25 and following of the Directive 2006/48/EC.

37. *Financial Collateral Comprehensive Method*

Under this valuation method, financial collateral as a credit risk mitigation technique is assigned a value after applying volatility adjustments, in order to take account of market price volatility. See Annex VIII of the Directive 2006/48/EC.

## **Definitions on Operational Risk data**

38. *Basic Indicator Approach*

Basic Indicator Approach for calculating the capital requirement for operational risk is a certain percentage of a relevant indicator, in accordance with the parameters set out in Annex X, Part 1 of the Directive 2006/48/EC, as provided in Section 4, Article 103.

39. *Standardised Approach*

Under the Standardised Approach for calculating the capital requirement for operational risk, the institutions shall divide their activities into a number of business lines and shall apply a certain percentage of a relevant indicator for each of these business lines, in accordance with Annex X, Part 2 of the Directive 2006/48/EC, as provided in Section 4, Article 104 of this Directive.

40. *Advanced Measurement Approaches*

Advanced Measurement Approaches for calculating the capital requirements for operational risk are based on the institutions' own internal risk measurement systems. Institutions must satisfy their

competent authorities that they meet the qualifying criteria set out in Annex X, Part 3 of the Directive 2006/48/EC, as provided in Section 4, Article 105 of this Directive.

41. *Own funds requirements for operational risk*  
The minimum level of own funds for operational risk as provided in Section 4, Article 102 of the Directive 2006/48/EC.

#### **Definitions on Market Risk data**

42. *Own funds requirements market risk*  
Total minimum level of own funds for market risk as defined by Article 75 (b) and Article 75 (c) of the [Directive 2006/48/EC](#).

43. *Own funds requirements standardised approach*  
Total minimum level of own funds as defined by Annex 1, III, IV & VI of Directive [2006/49/EC](#).

44. *Own funds requirements VAR*  
Total minimum level of own funds as defined by Annex V of the Directive 2006/49/EC.

45. *Own funds requirements standardised approach traded debt instruments*  
Total minimum level of own funds as defined by Annex 1, sections 1-12, sections 13-32, sections 41-56 and Annex VI of the Directive 2006/49/EC.

46. *Own funds requirements standardised approach equities*  
Total minimum level of own funds as defined by Annex 1, sections 1-12, sections 33-40, sections 41-56 and Annex VI of the Directive 2006/49/EC.

47. *Own funds requirements standardised approach foreign exchange*  
Total minimum level of own funds as defined by Annex III of the Directive 2006/49/EC.

48. *Own funds requirements standardised approach commodities*  
Total minimum level of own funds as defined by Annex VII of the Directive 2006/49/EC.

49. *Own funds requirements VAR defined towards risk categories*

Total minimum level of own funds as defined by Annex VIII of the Directive 2006/49/EC. Section 4 contains conditions for calculating specific risk associated with traded debt and equity positions by an internal model. If these conditions are not met by the institution, the standardized approach applies. Sections 8 and 9 also relate to *specific risks*. Reference to general interest rate and equity risk, foreign exchange risk and commodity risk is made in section 13.

## **Definitions on Supervisory actions and measures**

### 50. *Number of on-site inspections*

This refers to predefined examinations, conducted within the institution either by the supervisors' own staff or external auditors with a view to:

- providing independent verification that adequate internal governance (including risk management and internal control systems) exists at individual banks;
- determining that information provided by banks is reliable;
- obtaining additional information needed to assess the condition of the bank.

It does not include any other supervisory contact on-site, such as visits. It does, however, include regular on-site inspections.

### 51. *Number of overall-assessments performed*

These assessments refer to the review and evaluation as described in Article 124 of the Directive 2006/48/EC.

### 52. *Number of institutions for which Art 136 – 1 measures have been taken*

These measures refer to Article 136, section 1 of the Directive 2006/48/EC.

# Guidelines on Supervisory Cooperation for Cross-Border Banking and Investments Firms Groups

## GUIDELINES FOR CO-OPERATION BETWEEN CONSOLIDATING SUPERVISORS AND HOST SUPERVISORS<sup>31</sup>

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### EXECUTIVE SUMMARY

1. This paper sets out CEBS guidelines for establishing an enhanced framework for co-operation between consolidating supervisor and host supervisors (Guidelines). They contain sections on general cooperation, distinguishing between subsidiaries and branches, and guidance more specifically related to the approval process of model validation.
2. These Guidelines are primarily directed towards supervisory authorities but credit institutions and investment firms will be affected by the operational aspects of supervisory co-operation. The Guidelines are the starting point for substantial developments in the supervision

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<sup>31</sup> As to the history of this document, the guidelines for cooperation between consolidating supervisors and host supervisors can be found on the CEBS website: <http://www.c-eps.org/documents/Publications/Standards---Guidelines/files-from-old-website/GL09.aspx>

of cross-border groups, through the creation of operational network mechanisms. The exchange of relevant and essential information, consultation and proportionality are key to the supervisory challenges in the future.

3. This is an endeavour to respond to recent market developments. It also reflects the requirements of the Capital Requirements Directive (CRD)<sup>32</sup>. As banking groups are centralising their risk management activity there is a need to develop further an integrated, risk-based and coordinated approach to supervision. These Guidelines should therefore be of key interest to groups operating on cross-border basis in the EU.
4. The starting point for these Guidelines is the legal text, predominantly Articles 129, 131 and 132 of the [Directive 2006/48/EC](#), which set the statutory framework for a much enhanced collaborative approach to the supervision of cross-border banking groups. In line with the requirements of the Directive this approach will be based on information sharing including, where necessary, consultation on supervisory action (Article 132), on joint model validation under the lead of the consolidating supervisor (Article 129) and more generally on written arrangements for coordination and co-operation between home and host supervisors (Article 131). These and other CRD requirements have been fleshed out for practical application by the supervisory authorities being the prime addressees of these Guidelines. The proposed guidelines are intended to further CEBS' main objectives, which are to promote effective supervision of EU banking groups, to streamline the supervisory process by enhancing convergence of practice and standards and to develop operational network mechanisms underpinning supervisory coordination and co-operation. It is expected that these efforts will help avoid an excessive burden of supervision on EU banking groups.
5. Related issues such as the possible need to upgrade the EU framework for deposit insurance schemes, the lender of last resort function or crisis management provisions will not be addressed in this paper as they go beyond the scope of mere supervisory coordination and co-operation discussed here.
6. CEBS has elaborated on a practical framework for the Supervisory Review Process (SRP), comprising the Internal Capital Adequacy Assessment Process (ICAAP) and the Supervisory Review and Evaluation Process (SREP) and Guidance for the Model Validation Process.
7. For cross-border groups, all supervisors could be required – depending on the scope of application as defined by the CRD – to undertake the SREP within the respective Member States. For supervisory co-

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<sup>32</sup> The Capital Requirements Directive (CRD) contained in Directives 2006/48/EC and 2006/49/EC, which replaced Directives 2000/12/EEC and 93/6/EEC.

operation to be effective, the SREP should therefore be based on the same principles, applying similar procedures. This should result in:

- convergence of supervisory practice among EU supervisors, thus offering scope for coordinating supervisory actions and eliminate duplicate tasks; and
  - a proportionate and risk-based approach to supervisory co-operation, thereby avoiding unnecessary communication and redundant tasks, thus preventing the arrangements between home and host supervisors becoming administratively burdensome.
8. Within the framework set by Articles 129, 131, and 132 of the Directive 2006/48/EC, the extent of coordination, co-operation and information sharing will be influenced by the significance or systemic relevance of the entities, both within the group and in their local market(s). The consolidating supervisor and the host supervisor may have different views on the degree of significance or systemic relevance of the various entities and on the risks stemming from these entities for the group. Significance and systemic relevance remain relative concepts, to be assessed by the consolidating and host supervisors on a case-by-case basis, and determined by the consolidating supervisor for the purposes of the supervision on a consolidated basis. In making their assessment, supervisors should consider, at a minimum, the complexity, potential impact and size of the entity.
  9. This interaction gives shape to an integrated supervisory framework and relies materially on the exchange of information within the operational networks set up between the relevant consolidating supervisors and host supervisors. For certain matters, such as those related to local market characteristics, the host subsidiary supervisor will be best placed to collect and assess information that could be of interest to the consolidating supervisor. Likewise, there are matters for which the host supervisor may find it necessary to obtain information which is best made available by the consolidating supervisor. The information exchange process shall be proportionate and risk-focused to avoid unnecessary information exchanges. Drawing on communication within existing and further enhanced operational networks it shall also be as spontaneous as possible, allowing any supervisor to take the initiative to submit an issue deemed necessary to be raised. The information shall be communicated on a timely basis.
  10. Moreover, the co-operative framework should be neutral in the sense that it does not provide an incentive for groups to restructure. It should strive to eliminate duplication of work, which should reduce the burden on the industry.
  11. The outcome will be a practical framework for the Supervisory Review Process, comprising the Internal Capital Adequacy Assessment Process, the Supervisory Review Evaluation Process and the Approval

Process for Model Validation. The Guidelines will be further complemented with a practical transposition for specific cases; a section on model validation is therefore part of this paper. One for situations of crisis management is under elaboration.

- 11a. These CEBS Guidelines cannot govern supervisory cooperative arrangements between EU and non EU supervisors. Nevertheless, EU supervisors will take account of these Guidelines and framework in dealing with non EU supervisors. Further, EU supervisors will also continue to play an active role in the Basel AIG work that is seeking to promote global cooperation.
12. In drafting these Guidelines, CEBS has tested their application through a number of case studies, and will continue to explore the practicalities and efficacy of these proposals. The findings from the practical application of these guidelines will further influence this paper, as will any lessons from the Basel AIG process and the colleges being undertaken under the auspices of that body. The Guidelines will be subject to review as it appears desirable in the light of experiences from the application and in the case of legal changes.
- 12a. These Guidelines have been unanimously endorsed by CEBS Members in the spirit of further converging supervisory practices within the EU and in accordance with CEBS statement on the character of its publications.<sup>33</sup>

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<sup>33</sup> See Article 4.3 of CEBS Charter <http://www.c-ebs.org/aboutus/CEBS-charter.aspx>.

## GUIDELINES

### 1. Introductory statements

#### *1.1 Overview*

1. Over a period of years, European banking supervisors have developed and put into practice arrangements for co-operation and information-sharing between consolidating and host supervisors<sup>34</sup> within the legal framework of the responsibilities laid down in EU Directives. These arrangements have worked well up to this point, since the consolidating supervisor and the host supervisors each have a specific role to play in ensuring the effective supervision of cross-border European groups.<sup>35</sup>
2. Notwithstanding the demonstrated effectiveness of these arrangements, ongoing developments – including the introduction of a revised capital adequacy framework, the CRD, and the evolving structure of banking groups and systems across the EEA – make it necessary to refine them in order to further strengthen existing coordination and co-operation between supervisors.<sup>36</sup>
3. This paper puts forward guidelines underpinning cross-border supervisory co-operation and sets out a refined practical framework for co-operation and for the exchange of information. The objective is to promote efficient, coherent, and cost- and resource-effective cross-border supervision for the benefit of both supervisory authorities and supervised institutions. Increased co-operation between supervisors within operational networks cutting across consolidating supervisors and host supervisors will lead to a higher degree of commonality in supervisory standards, which should further improve supervisory efficiency. It will also contribute to efforts to promote convergence in supervisory practice, by fostering a better understanding of each others' methods and approaches. Indeed, co-operation and convergence will each reinforce the other, and together they will contribute to establishing and strengthening a common supervisory culture.<sup>37</sup>

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<sup>34</sup> The terminology used in this paper designates the home supervisor of a group as the 'consolidating supervisor,' the supervisor that awarded a licence to a subsidiary as the 'host subsidiary supervisor,' and the supervisor of a branch as the 'host branch supervisor.' The term 'host supervisor' includes both host subsidiary supervisor and host branch supervisor. This terminology is not entirely in accordance with the wording of EU Directives, but it elucidates the practical arrangements used in the supervision of a banking group.

<sup>35</sup> These guidelines can be equally applied to investment firm groups, where the investment firms are subject to the scope of the CRD.

<sup>36</sup> See also CEBS' Communication paper on the role and tasks (<http://www.c-ebs.org/documents/About-us/About-us-intro-page/CEBS.aspx>) of CEBS sub Chapter 'CEBS' objectives, tasks and tools'.

<sup>37</sup> See also CEBS' Communication paper on the role and tasks of CEBS sub Chapter 'Framework and market trends'.

4. Risks to an international banking group can arise in any of the countries in which it operates. Without an adequate financial structure and sound management practices, these risks can be transmitted across national borders from one part of the group to another. Adequate information systems are critical to managing these risks. Banking groups need to have accurate measurement systems, sound internal control systems and appropriate transparency policies in order to gather adequate information on the risks that they confront at the group level and at the level of their individual entities. CEBS is working to strengthen practices in these areas.<sup>38</sup>
5. The paper builds upon established practices of supervisory co-operation, on practical guidance issued by international bodies (both existing and under preparation) and on the legal and regulatory framework of the EU and its Member States.
6. This legal and regulatory framework aims at ensuring that:
  - Banking groups and their individual institutions are adequately capitalised;
  - Banking groups and their individual institutions identify, manage and evaluate the risks of their businesses adequately; and
  - Group structures are transparent, enabling, on the one hand, market participants to discern and evaluate the relationships within the group and, on the other hand, its individual institutions to strive for adequate market exposure and evaluation and for a transparent view of group relationships; and
  - Proper governance and internal control provisions are in place at all levels of banking groups.
7. The general principles for cross-border co-operation, as set out in this paper, apply directly and in full whenever supervisors are involved in supervision on a cross-border basis, e.g. for assessing the "fit and proper" qualification of a banking group's structure or of its shareholders or for evaluating the adequacy of organisational structures. For practical reasons the paper will, however, illustrate these principles by articulating them around the various steps of the SREP, being one of the key components of the overall supervisory process. These illustrative parts of the text do by no means imply a prescriptive or unique guideline on how to organise the SREP; but they offer a flexible framework on how this process might be conceived in general. On a case by case basis and taking due account of the effective structure of the banking groups concerned, supervisors

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<sup>38</sup> See for example CEBS' Communication paper on the role and tasks of CEBS; CEBS Guidelines on the Application of the Supervisory Review Process under Pillar 2; and CEBS Guidelines on the framework for Supervisory Disclosure.

should thus modulate their approach to the SREP with a view to optimising its effectiveness and efficiency.

## **1.2 Legislative background**

8. Current EU legislation provides Member States with a comprehensive set of rules for banking activity, including references to the respective roles and responsibilities of supervisory authorities.
9. A number of significant legislative proposals that have recently been launched or approved within the EU will require supervisors to co-operate more closely, either because they explicitly require enhanced co-operation, or because they impose new supervisory obligations. This paper focuses on how supervisors should work together to achieve a more effective and efficient interaction, in terms of both information exchange and practical co-operation, in order to make the prudential supervisory regime under the CRD – particularly under the provisions relating to supervision on a consolidated basis – more effective and efficient.<sup>39</sup>
10. Notwithstanding the legislative changes mentioned above, supervisors remain responsible for the overall supervision of the entities they authorise. The responsibilities of the consolidating supervisor will encompass the supervision of group-wide functions and the overall solvency of the consolidated group. Thus, supervisory powers rest substantially with the authorities that license individual institutions, and consolidating supervisors will have to rely on their host peers for effective intervention at subsidiary levels in many areas.
11. It should be kept in mind that the practical arrangements set out in this paper are intended only to improve efficiency and effectiveness in the performance of supervisory tasks. They can never lead to any alteration in the responsibilities and powers of supervisors as laid down in the CRD. It should be emphasized that the Consolidated Banking Directive (repealed by the Directive 2000/12/EEC) and the CRD provide for the possibility (never yet been put into practice) for a host supervisor to delegate full responsibility for the supervision of a subsidiary to the consolidating supervisor. Any such delegation according to Article 131 of the Directive 2006/48/EC, should be based on a formal agreement that stipulates responsibilities and refines practical arrangements on the way supervisory tasks are organised.
12. Other changes in EU legislation, regarding company law or tax law, could indirectly impact the responsibilities and powers of supervisors concerned. An example of this is the European Company Statute, which might facilitate the conversion of banking group subsidiaries into

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<sup>39</sup> Including Articles 129, 131 and 132 of the Directive 2006/48/EC ([http://eur-lex.europa.eu/LexUriServ/site/en/oj/2006/l\\_177/l\\_17720060630en00010200.pdf](http://eur-lex.europa.eu/LexUriServ/site/en/oj/2006/l_177/l_17720060630en00010200.pdf)).

branches, potentially leading to the emergence of more systemically relevant branch structures in some countries. In a similar vein, it might become easier to relocate group headquarters between Member States. These possible evolutions have to be kept in mind when developing a framework for co-operation between consolidating supervisor and host supervisors, in particular with regard to branches: the framework must be sufficiently flexible to allow for adequate supervisory responses.

13. This legislative background defines the scope and provides the basic elements for a framework for enhanced co-operation. The guidelines set out in this paper should always be applied within the context of applicable EU and national law and the requirements in force in the various Member States. Thus, for example, arrangements for exchanging information pertaining to a group need to respect EU and national requirements for preserving confidentiality. Measures may need to be put in place to ensure that supervisors are able to satisfy themselves that adequate safeguards exist.

### ***1.3 The European Financial Market***

14. Some groups – particularly larger groups – are centralising an increasing number of key functions and outsourcing other functions, while continuing to use local subsidiaries as the preferred method of entry into foreign markets. As a result, there may no longer be a direct relationship between the legal structure and the operational structure of the group.
15. As such trends in the European financial markets are essentially market-driven, it is impossible to predict in which areas and to what extent they will continue. The goal of supervisors is to develop a comprehensive framework of co-operation which will ensure financial stability and which is also sufficiently flexible to adapt to a changing environment.

### ***1.4 Supervisory considerations with regard to these changes***

16. These trends in the European banking environment are likely to reinforce the legitimate interest of all competent authorities in the supervision of banking groups. A well-conceived framework for supervisory co-operation could help ensure that:
  - the supervision of a banking group on a consolidated basis is organised, planned, and carried out in a coordinated and efficient manner; and
  - the consolidating supervisor is fully aware of the concerns, policies, strategies, and risk assessment methodologies of the host subsidiary supervisors, especially those that supervise

subsidiaries which are of significant importance to the group's overall risk profile.

17. Both consolidating and local host supervisors have a legitimate interest and role in the supervision of EU banking groups. The consolidating supervisor has prudential responsibility for the group as a whole as specified in Article 125 and 129 of the [Directive 2006/48/EC](#), building on his oversight of the group's structure, activities and the risks it is facing. The role and responsibilities of a host supervisor differ depending of whether the entity being supervised is a branch or a subsidiary. The host subsidiary supervisor is responsible for supervision of subsidiaries and for their obligations towards their depositors. Moreover, the host supervisor can meaningfully contribute to the overall supervisory process over a group as it can offer:
  - a depth of knowledge of the local banking landscape and local market conditions that is not available to the consolidating supervisor. This capacity to understand and assess local risks faced by subsidiaries and branches will be essential in supervising the more sensitive risk-based approaches to the assessment of capital adequacy.
  - For a subsidiary, it is the supervisor possessing the necessary legal prerogatives and authority to impose supervisory or precautionary measures on subsidiaries located within their jurisdictions.
  - It can undertake supervisory tasks more efficiently for entities in their jurisdictions, and can communicate more easily with these entities due to their geographical and cultural proximity.
18. Co-operation and information sharing within operational networks cutting across consolidating supervisors and host supervisors involved in the supervision of cross-border groups is essential for effective and efficient supervision. Further, the selected structure of co-operation, such as a supervisory college, bi- or multilateral, should reflect both the group's structure and the supervisors' requirements. Supervisory co-operation needs to go beyond the mere exchange of information, although information exchange remains the foundation as well as a key feature of co-operative arrangements.
19. Because the new capital adequacy rules involve supervisors more deeply in the capital adequacy assessment process, under both Pillar 1 (for example, in the Internal Ratings Based (IRB) and Advanced Measurement (AMA) approval processes) and Pillar 2, they increase the demands on supervisory resources. They also demand new skills and expertise from supervisors, particularly where a banking group has adopted the advanced approaches to risk measurement.
20. It is in the mutual interest of consolidating and host supervisors to develop a model of supervisory co-operation which optimises the use of their collective supervisory resources, avoids the performance of redundant or duplicative supervisory tasks, enhances and facilitates

the flow of information, and generally promotes effective and efficient supervision across a group. The enhanced dialogue between supervisors and the coordination by the consolidating supervisor should be designed to address these objectives. CEBS will continue its efforts for enhancing convergence, as in all areas of supervision. One main instrument in this respect being the open, but confidential, exchange of experience. This will enhance the likelihood of consensus.

21. The co-operative framework should be neutral in the sense that it does not provide an incentive for groups to restructure. It should strive to eliminate duplication of work, which should reduce the burden on the industry.
22. With respect to the common regulatory framework and its current development, the supervisory framework should also contribute to enhancing the consistency of the supervisory assessment throughout the whole group and should make clear which tasks are to be carried out by the different supervisors involved at the group and local level, in particular under Pillar 2. Supervisors will inform the group of relevant elements of the supervisory arrangements, such as the allocation of tasks.
23. Within the framework of the CRD, certain tasks may be undertaken by one supervisor acting on behalf of another, thus making optimal use of resources and expertise. Supervisors may consider the resource implications, including the cost impact of such co-operation.

## **1.5 Framework**

### ***Basic principles***

24. The Basel Committee of Banking Supervisors has published guidance on cross-border co-operation for supervisors of international groups.<sup>40</sup> The Basel Committee guidance takes the form of high-level principles for co-operation which address how best to minimise the burden of the new prudential capital regime.
25. These principles provide a good starting point for a model of co-operation between supervisors. However, a more integrated and practical co-operative framework should be developed that responds to the EU's single-market goals and to the evolving legislative framework mentioned above. Moreover, the CRD expands on the Basel principles by clearly delineating the rights and responsibilities of the consolidating supervisor and host supervisors with respect to subsidiaries and branches, and these additional principles will need to be incorporated into the EU framework. In particular, it is necessary to:

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<sup>40</sup> High-level principles for the cross-border implementation of the New Accord (August 2003) and Principles for the home-host recognition of AMA operational risk capital (January 2004).

- i. differentiate between the host supervisors of branches and the host supervisors of subsidiaries. This is the reason for the 'two scenarios' approach adopted in the practical framework set out in this paper;
- ii. take into account the fact that the CRD identifies features and functions<sup>41</sup> which are likely to be centralised within a group, with the result that the consolidating supervisor and the host subsidiary supervisors are interested in many of the same group functions;
- iii. coordinate supervisory approaches, to the extent possible, in order to streamline the overall supervision of the group. The CRD sets out several provisions that require co-operation, and the EU framework should conform to those provisions.

### ***Overview of the EU framework***

- 26. According to the CRD and its principle of proportionality, the consolidating supervisor is responsible for planning and coordinating supervisory activities and for undertaking the overall assessment of the group. The consolidating supervisor should therefore initiate a process of consultation between the individual supervisors involved and take the lead in establishing co-operative arrangements based on the SREP.<sup>42</sup>
- 27. CEBS has elaborated a practical framework for the Supervisory Review Process and its two main components: the ICAAP and the SREP.<sup>43</sup>
- 28. For cross-border groups, all supervisors could be required – depending on the scope of application as defined by the CRD – to undertake the SREP within the respective Member States. For supervisory co-operation to be effective, the SREP should therefore be based on the same principles, applying similar procedures. This should result in:
  - i. convergence of supervisory practice among EU supervisors, which will expand the scope for coordinating supervisory actions and eliminating duplicate tasks; and
  - ii. a proportionate and risk-based approach to supervisory co-operation, which will avoid information overload and unnecessary tasks and thereby prevent the arrangements from becoming administratively burdensome.
- 29. The extent of co-operation and information sharing will be influenced by the significance or systemic relevance of the entities, both within the group and in their local market(s). The consolidating supervisor

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<sup>41</sup> For example board and senior management oversight, sound capital assessment, comprehensive assessment of risks, monitoring and reporting, and internal control systems.

<sup>42</sup> See Appendix I for an overview of this framework.

<sup>43</sup> CEBS Guidelines on the Supervisory Review Process.

and the host supervisors may have different views on the degree of significance or systemic relevance of the various entities and on the risks stemming from these entities for the group. Significance and systemic relevance remain relative concepts, to be assessed by the consolidating and host supervisors on a case-by-case basis, and determined by the consolidating supervisor for the purposes of the supervision on a consolidated basis. In making their assessment, supervisors should consider, at a minimum, the complexity, potential impact and size of the entity.

30. The assessment of significance may consider a broad set of factors, taken into account separately or in combination. For assessing significance a non-exhaustive list of factors is listed below. Supervisors are invited to consider a wider range of criteria whenever these are deemed appropriate.

For measuring the impact on the host local market:

- the market share of the entity, on either the assets or liabilities side (e.g. in relation to (mortgage) loans, deposits, or savings products);
- the role of the entity in specific markets (e.g. principal market-maker);
- whether the entity is an integral part of the infrastructure of the financial system (e.g. payment systems, exchanges and clearing houses);
- the extent to which the entity provides liquidity to the market (either generally or to individual key markets).

For measuring the impact on the group as a whole:

- the contribution of the entity to the performance and earnings of the group as a whole (e.g. to overall capital requirements, turnover, or pre-tax profit);
- the risk of activities undertaken in the entity;
- the group's organisational structure, systems, and controls; its risk management functions; and senior management oversight to monitor and control risks in the entities;
- the extent to which the entities are autonomous;
- the correlation of risks across entities.

31. The consolidating supervisor and the host supervisors may each have a different focus in their supervision of a given entity. It is therefore important for them to communicate to each other their assessment of the entity's significance and the rationale for that assessment, and to take each others' assessments into account in structuring their co-operation. A periodic review of the assessment is recommended.

32. A key aspect of coordinating supervisory activities is developing a common understanding, on the part of all the supervisors concerned, of a group's internal governance, internal strategies, plans and processes, particularly as they relate to the group's application of the advanced approaches under Pillar 1 and the formulation of its ICAAP under Pillar 2. The ICAAP is an important input to an efficient supervisory process. In the absence of a clear mutual understanding of a group's internal plans and timetables, it will be difficult for supervisors to coordinate their approaches effectively.
33. In parallel with discussions with a group about its governance, strategies, plans, and processes, the consolidating supervisor should keep the group informed of the supervisory approach to the group at the consolidated and individual levels. This process should engender greater mutual trust between institutions and supervisors.
34. Consolidating supervisors and host supervisors should have written arrangements specifying their respective roles in the supervisory co-operation. Written arrangements have the advantage of providing commonality of standards and certainty of expectations. The arrangements may take the form of bilateral or multilateral Memoranda of Understanding (MoUs), or ad hoc arrangements tailored to a specific cross-border banking group, depending on the structures of the supervised institutions.

#### **1.6. Model of co-operation**

##### ***Guidelines overarching the practical co-operative framework***

35. The consolidating supervisor and host supervisors should co-operate to ensure effective and efficient supervision of EU banking groups on a consolidated and individual basis. They have a mutual interest in strengthening the framework for co-operation. The consolidating supervisor may need information or assistance from the host supervisors in order to be able to properly assess the group's capital adequacy on a consolidated basis, paying due consideration to local conditions. Conversely, host subsidiary supervisors may need information from the consolidating supervisor concerning systems and processes that are centralized at group level, in order to assess the capital adequacy of subsidiaries.
36. Enhanced co-operation should seek to avoid an undue burden on supervised institutions. In particular, part of the SRP under Pillar 2 will consist of a dialogue with the institution in the course of reviewing its ICAAP. To avoid burdensome duplication of effort, the respective roles of the consolidating supervisor and the host supervisors in this dialogue should be clearly defined.
37. The co-operation arrangements for the supervision of banking groups should:

- i. be conducted within a risk-based approach to supervision, with due consideration to the banking group's structure, systems and controls, and management. The degree of centralisation in management (banks operating with a business-line model versus banks operating on a legal-entity basis) might be used as an orientation;
  - ii. be proportionate;
  - iii. take into account the degree of significance of subsidiaries in the financial system of the host countries;
  - iv. be transparent to the supervised group. The consolidating supervisor should be responsible for keeping the group's senior management informed of the overall arrangements for supervising the group. Host supervisors should nevertheless inform their contacts of matters relevant to the entities within their remit of their supervision;
  - v. be neutral with respect to the banking group's business model and structure;
  - vi. include the common understanding of groups' internal strategies, plans and processes. Without such understanding, effective coordination of approaches by supervisors would be very difficult to achieve;
  - vii. be regarded as subject to refinements, should new structural changes within the European banking system materialize, or whenever otherwise deemed necessary.
38. Within the legal framework as laid down in the CRD, assigning to the authority having authorized the credit institution full responsibility also for its branches, similar co-operation agreements can be established between the consolidating supervisor and host supervisor(s) with regard to systemically relevant branch(es), also having regard to each supervisors' particular responsibilities for e.g. local financial stability and liquidity. Such agreements will pertain primarily to information exchange and state clearly that, whenever an authority accepts to perform any work on behalf of another with respect to a branch, it does so within the framework of both the requesting and accepting authority's competence and legal responsibilities.

### ***Information exchange***

39. A free flow of information is important in building co-operation. Information exchange is the starting point for developing sound relationships between supervisors, and building trust and confidence in their respective assessment processes. It is also a core element in planning supervisory tasks and coordinating the activities of supervisors under the umbrella of the consolidating supervisor. A

proposed framework for information exchange in the context of ongoing supervision is set forth below. It is essential that any information exchange starts by communicating the status quo on these issues.

40. The communication of information between supervisors should:
- be a two-way process, but should be balanced to reflect the needs of the supervisors involved. For certain matters, such as those related to local market characteristics, the host subsidiary supervisor will be best placed to collect and assess information that could be of interest to the consolidating supervisor. Likewise, there are matters for which the host supervisor may find it necessary to obtain information which is best made available by the consolidating supervisor;
  - be proportionate and risk-focused, to avoid unnecessary information flow; and
  - be as spontaneous as possible, allowing any supervisor to take the initiative, and should provide information on a timely basis.
41. A communication strategy should be developed under the auspices of the consolidating supervisor, in full consultation with other concerned supervisors. The strategy should coordinate at a minimum the gathering and the dissemination of information. It should have regard to defining by whom and to whom information should be disseminated, be it between host supervisors and (sub)consolidating supervisor or mutually between host supervisors. In particular, supervisors should ensure that:
- the consolidating supervisor has unfettered access to all relevant information;
  - essential information and, if deemed useful, relevant information is provided to all supervisors at an appropriate level; and
  - no undue limitations are imposed on spontaneous communication between supervisors.

The process may naturally lead to an asymmetric flow of information.

42. Article 132 of the [Directive 2006/48/EC](#) distinguishes between two types of information: 'essential information,' which supervisors shall communicate on their own initiative, and 'relevant information,' which they shall communicate on request. Beyond the exchange of 'essential' and 'relevant' information, supervisors will exercise restraint in order to avoid disproportionate or redundant flows of information.
43. According to the CRD, information shall be regarded as essential if it could materially influence another Member State's assessment of the financial soundness of a credit institution. The table below provides an illustrative list of essential information.

44. Although the CRD does not define ‘relevant information,’ this is understood to mean information that is relevant to the performance of another supervisor’s obligations. Supervisors should agree on the scope of relevant information to be communicated, and may consider specifying the content, format, and the manner in which information will be exchanged (e.g. contacts, regular conference calls, regular meetings, written agreements etc). Supervisors requesting information should state clearly the purpose for which the information is requested. This will help to assess relevance.
45. The CRD states that the supervisors responsible for consolidated supervision of EU parent credit institutions shall provide host subsidiary supervisors with all relevant information. In determining the extent of relevant information, the importance of the subsidiaries within the financial system of the Member States where they are licensed should be taken into account.
- 45a. If structural changes in a group entail the involvement of new or the exclusion of existing supervisors, the consolidating supervisor will monitor a proper handover and an effective continuation of the cooperative process.
46. The following table provides an illustrative list of essential information that could be exchanged between the consolidating supervisor and host supervisors.

| Objectives                                                                                                                                                                                                              | Essential information to be communicated by the consolidating supervisor to host supervisors on its own initiative                                                                                                                                                                                                                                                                                                                                               | Essential information to be communicated by the host supervisors to consolidating supervisor on their own initiative                                                                                                                                                                                                                                                                                                                                    |
|-------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|---------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| 1. Be aware of significant changes in the group structure and in the authorities involved in the group’s supervision at the consolidated, sub-consolidated and local levels, for significant entities within the group. | <ul style="list-style-type: none"> <li>• Significant changes in the group structure, including all major institutions (including investment firms) in the group.</li> <li>• Significant changes in the competent authorities involved in the supervision of the group.</li> <li>• The group structure should be understood as encompassing: <ul style="list-style-type: none"> <li>- the legal structure of the group and the location of</li> </ul> </li> </ul> | <ul style="list-style-type: none"> <li>• Significant changes in the structure of significant supervised entities within the group.</li> <li>• Significant changes in the competent authorities involved in the supervision of these entities.</li> <li>• The structure of significant supervised entities should be understood as encompassing: <ul style="list-style-type: none"> <li>- the legal structure of the entities and</li> </ul> </li> </ul> |

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|                                                                                                                                                                                                  | <p>significant business units;</p> <ul style="list-style-type: none"> <li>- significant investments in non financial entities (e.g. insurance);</li> <li>- significant capital links between entities; and</li> <li>- significant qualifying holdings.</li> </ul> <ul style="list-style-type: none"> <li>• Changes in the levels (individual, sub-consolidated, consolidated) at which capital requirements are applied within the group.</li> </ul>                                                | <p>the location of significant business units;</p> <ul style="list-style-type: none"> <li>- significant investments in non financial entities (e.g. insurance);</li> <li>- significant capital links between entities; and</li> <li>- significant qualifying holdings.</li> </ul> <ul style="list-style-type: none"> <li>• Changes in the levels (individual, sub-consolidated, consolidated) at which capital requirements are applied.</li> </ul> |
| <p>2. Be aware of significant changes in the way information is reported to different supervisors within a group and exchange on methodologies used to review that information.<sup>44</sup></p> | <ul style="list-style-type: none"> <li>• Changes in the procedures for the collection of information from the institutions in a group, and in the verification of that information. This covers: <ul style="list-style-type: none"> <li>- the information to be collected by the different supervisors;</li> <li>- the means by which that information will then be disseminated;</li> <li>- any additional information flows from host supervisors of significant entities.</li> </ul> </li> </ul> | <ul style="list-style-type: none"> <li>• Changes in the procedures for the collection of information from the institutions in a group, and in the verification of that information. This covers: <ul style="list-style-type: none"> <li>- the information to be collected by the different supervisors;</li> <li>- any additional information flows from host supervisors of significant entities.</li> </ul> </li> </ul>                           |
| 3. Communicate                                                                                                                                                                                   | <ul style="list-style-type: none"> <li>• Adverse</li> </ul>                                                                                                                                                                                                                                                                                                                                                                                                                                         | <ul style="list-style-type: none"> <li>• Adverse</li> </ul>                                                                                                                                                                                                                                                                                                                                                                                         |

<sup>44</sup> See also CEBS Guidelines on Common Reporting (COREP); and CEBS Guidelines on Financial Reporting (FINREP).

|                                                                                            |                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                |                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                             |
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| <p>difficulties that have potentially significant spill-over effects within the group.</p> | <p>developments, such as:</p> <ul style="list-style-type: none"> <li>- matters which cast doubt on the viability of the group as a going concern;</li> <li>- factors which suggest a potentially high risk of contagion (significant intra-group transactions);</li> <li>- significant developments in the financial position of the group: declining capital ratios, losses, loss of liquidity, increase in funding costs;</li> <li>- major fraud.</li> </ul> <ul style="list-style-type: none"> <li>• Major sanctions and exceptional measures taken by competent authorities.</li> <li>• Other matters, paying due consideration to how the group is organised (centralised versus decentralised functions): <ul style="list-style-type: none"> <li>- changes in organisation or senior management that have a significant impact on internal controls, culture, or risk management;</li> <li>- changes in strategy.</li> </ul> </li> </ul> | <p>developments, such as:</p> <ul style="list-style-type: none"> <li>- matters which cast doubt on the viability of the subsidiary as a going concern;</li> <li>- excessive reliance on intra-group transactions or parental support (e.g. guarantees);</li> <li>- significant developments in the financial position of the subsidiary: declining capital ratios, losses, loss of liquidity, increase in funding costs;</li> <li>- major fraud.</li> </ul> <ul style="list-style-type: none"> <li>• Major sanctions and exceptional measures taken by competent authorities.</li> <li>• Other matters, paying due consideration to how the group is organised (centralised versus decentralised functions): <ul style="list-style-type: none"> <li>- changes in organisation or senior management that have a significant impact on internal controls, culture, or risk management;</li> <li>- changes in strategy.</li> </ul> </li> </ul> |
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## ***Practical framework (group and subsidiary)***

### Planning and coordination

47. Individual supervisors retain at all times full responsibility for risk assessments, planning of supervisory programmes, and supervisory actions directed at entities for which they have legal responsibility. In accordance with the CRD, the consolidating supervisor shall coordinate the exchange of information and other supervisory activities, with a view to avoiding unnecessary communication and duplication of tasks for both supervisors and supervised institutions.
48. The following tables highlight cross border implications, along each step of a generic risk assessment, as well as the tasks or considerations by the supervisors involved to address these implications. At each step, the coordinating role of the consolidating supervisor in information exchange and in the planning of supervisory activities, in line with the CRD provisions, is kept in mind with a view to avoid unnecessary communication and duplication of tasks for both supervisors and supervised institutions.
49. Those steps are designed as general guidelines that can be adapted by competent authorities on a case-by-case basis according to the concrete needs of co-operation between the parties.

#### *50. Step 1 – initiation of process*

The consolidating supervisor will undertake a preliminary risk assessment of the group, while the host subsidiary supervisor will undertake a preliminary assessment of the group's subsidiaries.

Through dialogue with the host supervisors involved in the group's supervision, the consolidating supervisor will design a communication strategy proportionate to the involvement of other competent authorities in the group's supervision.

| <b>Cross-border implications</b>                               | <b>Tasks or considerations for the consolidating supervisor</b>                                                                                                                                                                       | <b>Tasks or considerations for the host subsidiary supervisor<sup>45</sup></b>                                                                                                                                                                                              |
|----------------------------------------------------------------|---------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|-----------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| Preliminary assessment of cross-border issues within the group | <ul style="list-style-type: none"> <li>• Identify the group's structure, key business and control risks, and business units.</li> <li>• Identify all EU and third-country supervisors involved in the group's supervision.</li> </ul> | <ul style="list-style-type: none"> <li>• Through dialogue with the subsidiary:               <ul style="list-style-type: none"> <li>- identify centralised functions;</li> <li>- identify knowledge gaps, especially those potentially linked to the</li> </ul> </li> </ul> |

<sup>45</sup> The need to communicate and co-operate with all host supervisors on the basis of proportionality most likely will not prevent that the risk assessment at the group level will most naturally focus on significant subsidiaries.

|  |                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                    |                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                            |
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|  | <ul style="list-style-type: none"> <li>• Through dialogue with the group (or parent undertaking): <ul style="list-style-type: none"> <li>- map the significant foreign subsidiaries to be discussed and agreed with the relevant host supervisors;</li> <li>- undertake a preliminary risk assessment;</li> <li>- identify centralised control arrangements/functions (e.g. IT/central audit);</li> <li>- understand group implementation plans for the advanced approaches and the ICAAP, and how they are intended to be rolled out across the group and its subsidiaries;</li> <li>- identify knowledge gaps concerning foreign businesses and subsidiaries.</li> </ul> </li> <li>• Through dialogue with host supervisors: <ul style="list-style-type: none"> <li>- identify the host supervisors of significant subsidiaries of the group;</li> <li>- identify the sub-consolidated supervisors of the group;</li> <li>- identify information that might need to be communicated to other supervisors;</li> <li>- identify information</li> </ul> </li> </ul> | <p>centralisation of the functions mentioned above;</p> <ul style="list-style-type: none"> <li>- identify any knowledge gaps concerning the position or involvement of a parent company which might be relevant for supervision on a solo or sub-consolidated basis.</li> </ul> <ul style="list-style-type: none"> <li>• Through dialogue with the consolidating supervisor: <ul style="list-style-type: none"> <li>- identify any other supervisors with whom the host supervisor may need to communicate – although all communication should pass through the consolidating supervisor;</li> <li>- identify the information that might need to be communicated to other supervisors;</li> <li>- identify information to be obtained from the consolidating supervisor for local supervision;</li> <li>- agree on information to be gathered locally and shared with the consolidating supervisor.</li> </ul> </li> </ul> |
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|                                                                                                                                        | about significant subsidiaries to be obtained from host supervisors.                                                                                                                                                                                                                                                                                                                                                                                                          |                                                                                                                                                                                                                                                                                                                                                                                     |
| Establish a communication strategy between all supervisors, proportionate to the involvement of the different supervisory authorities. | <ul style="list-style-type: none"> <li>Establish a communication strategy with all host supervisors, proportionate in term of contents and timeliness.</li> </ul>                                                                                                                                                                                                                                                                                                             |                                                                                                                                                                                                                                                                                                                                                                                     |
| Agreement on significant subsidiaries in the group for the purpose of group and subsidiary supervision.                                | <ul style="list-style-type: none"> <li>Identify significant subsidiaries, from the consolidating supervisor's perspective, for the purpose of consolidated supervision, and inform the host supervisors of significant subsidiaries accordingly.</li> <li>Consult host supervisors of significant subsidiaries on the relative significance of the subsidiaries.</li> <li>Agree on significant subsidiaries with the host supervisors of significant subsidiaries.</li> </ul> | <ul style="list-style-type: none"> <li>Inform the consolidating supervisor whether the subsidiary is considered significant or not to their supervisory objectives and the criterion for their assessment of significance. They should be prepared to discuss and justify their determination.</li> <li>Agree on significant subsidiaries with consolidating supervisor.</li> </ul> |

*51. Step 2 – risk identification and assessment*

The consolidating supervisor and the host subsidiary supervisors complete their respective risk assessments of the group and its subsidiaries by bridging their knowledge gaps.

| <b>Cross-border implications</b>             | <b>Tasks or considerations for the consolidating supervisor</b>                                         | <b>Tasks or considerations for the host subsidiary supervisor</b>                                                                       |
|----------------------------------------------|---------------------------------------------------------------------------------------------------------|-----------------------------------------------------------------------------------------------------------------------------------------|
| Consolidating supervisor and host subsidiary | <ul style="list-style-type: none"> <li>Produce a composite picture of the group based on the</li> </ul> | <ul style="list-style-type: none"> <li>Communicate: <ul style="list-style-type: none"> <li>- risk assessments of</li> </ul> </li> </ul> |

|                                                                                                                                                                                                                                                                                      |                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                              |                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                  |
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| <p>supervisors need to fully understand the risks of the group and its subsidiaries.</p> <p>Information gaps in individual supervisors' knowledge need to be plugged.</p> <p>Identify shared/common risks to objectives.</p> <p>Identify significant areas for local discretion.</p> | <p>consolidating supervisor's own knowledge and input from the host subsidiary supervisors.</p> <ul style="list-style-type: none"> <li>- the composite picture should include the essential information noted above (see Para 46 first box).</li> </ul> <ul style="list-style-type: none"> <li>• Communicate a provisional overall assessment of the group and of centralised operations to all host subsidiary supervisors, including: <ul style="list-style-type: none"> <li>- group objectives, strategies, policies, and processes;</li> <li>- identification of significant areas of focus for the on-site assessment.</li> </ul> </li> <li>• The extent of the provisional assessment will vary depending upon the significance of the subsidiary (host supervisors of significant subsidiaries should receive more information than others).</li> <li>• Discuss the provisional assessment with host supervisors of significant subsidiaries, for example by convening a meeting or by bilateral or written procedure with the aim of agreeing on key risks and objectives.</li> <li>• Establish a process to deal with local discretions.</li> </ul> | <p>the subsidiary to the consolidating supervisor;</p> <ul style="list-style-type: none"> <li>- the subsidiary's individual objectives, strategies, policies, processes, etc. to the consolidating supervisor;</li> <li>- on-site inspection programmes for significant subsidiaries, if requested by the consolidating supervisor.</li> </ul> <ul style="list-style-type: none"> <li>• Discuss their provisional assessments with the consolidating supervisor with the aim of agreeing on key risks and objectives.</li> </ul> |
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52. Step 3 - Planning supervisory action

Supervisors plan their supervisory actions (e.g. on-site inspections and other procedures) in response to the risks and objectives identified in the risk assessment stage.

| <b>Cross-border implications</b>                                                                                 | <b>Tasks or considerations for the consolidating supervisor</b>                                                                                                                                                                                                                                                                                                                                                                                                                                                                           | <b>Tasks or considerations for the host subsidiary supervisor</b>                                                                                                                                                                                                                                                                                                                      |
|------------------------------------------------------------------------------------------------------------------|-------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|----------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| <p>Identification of supervisory tasks, with the aim of eliminating duplicate tasks.</p>                         | <ul style="list-style-type: none"> <li>• Initiate a consultation process with host supervisors of significant subsidiaries to identify opportunities to coordinate their respective tasks:               <ul style="list-style-type: none"> <li>- identify areas of mutual interest and common tasks: on-site inspections, compliance requests, data requests, senior management concerns, audit concerns, quality of earnings concerns, etc;</li> <li>- identify where joint inspections might be more efficient.</li> </ul> </li> </ul> | <ul style="list-style-type: none"> <li>• Participate in the consultation initiated by the consolidating supervisor with the aim of reaching a consensus on common tasks.</li> </ul>                                                                                                                                                                                                    |
| <p>Allocation of tasks to achieve more effective supervision (if no common tasks are planned or identified).</p> | <ul style="list-style-type: none"> <li>• Identify tasks that the consolidating supervisor may wish to allocate to host supervisors of significant subsidiaries, and initiate discussions with them.</li> <li>• Discuss tasks that the consolidating supervisor could undertake on their behalf of the host supervisor (e.g. in relation to centralised functions such as internal audit).</li> <li>• Identify cross-border</li> </ul>                                                                                                     | <ul style="list-style-type: none"> <li>• Discuss whether to undertake tasks on behalf of the consolidating supervisor if requested.</li> <li>• Identify tasks that may be allocated to the consolidating supervisor, and initiate discussions with the consolidating supervisor. The host supervisors of significant subsidiaries will need to justify to the consolidating</li> </ul> |

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|                                                                                                                                                                                                                                                                                                                                                       | tasks that should be accomplished exclusively at group level.                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                        | supervisor why these tasks need to be performed.                                                                                                                                                                                                                                                                                                                                                                                                                                                                    |
| <b>Planning mutually agreed individual supervisory tasks</b>                                                                                                                                                                                                                                                                                          |                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                      |                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                     |
| <p>Determine the most appropriate collaborative model for planning individual supervisory tasks.</p> <p>Matters to plan:</p> <ul style="list-style-type: none"> <li>- division of tasks;</li> <li>- resourcing (perform or perform by a single supervisor);</li> <li>- operational lead;</li> <li>- prioritisation ;</li> <li>- timetable.</li> </ul> | <ul style="list-style-type: none"> <li>• Initiate consultation with the host supervisor of significant subsidiaries as to which model should be adopted (e.g. bilateral, multilateral, or a combination of the two). The consolidating supervisor ultimately decides on the co-operation model to be adopted.</li> <li>• If a multilateral approach is adopted, the consolidating supervisor should organise and chair the process. <ul style="list-style-type: none"> <li>- invite all host supervisors of significant subsidiaries to a meeting;</li> <li>- send out a draft agenda (including objectives) for the meeting;</li> <li>- communicate the outcome of this dialogue to all host supervisors of significant subsidiaries.</li> </ul> </li> <li>• Lead work on centralised functions (planning and operational lead): <ul style="list-style-type: none"> <li>- decide to invite host supervisors of significant subsidiaries to assist in work on</li> </ul> </li> </ul> | <ul style="list-style-type: none"> <li>• Enter into consultation with the consolidating supervisor and possibly other host supervisors.</li> <li>• Choose whether to participate in a multilateral procedure.</li> <li>• Lead the work on subsidiaries (planning and operational lead): <ul style="list-style-type: none"> <li>- if invited by the consolidating supervisor to assist with centralised functions, host supervisors of significant subsidiaries can choose whether to accept.</li> </ul> </li> </ul> |

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|  | <p>centralised functions;</p> <ul style="list-style-type: none"> <li>- choose to participate in work on subsidiaries, but the host supervisor of significant subsidiaries has the day-to-day operational lead.</li> </ul> |  |
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53. Step 4 - Performing supervisory tasks

The respective supervisors undertake on-site inspections and other procedures in response to their risk assessment of the group and its subsidiaries. These inspections and procedures will include matters specific to the group or individual subsidiaries in addition to matters of mutual interest.

| <b>Cross-border implications</b>                                                                                                                   | <b>Tasks or considerations for the consolidating supervisor</b>                                                                                                                                                                                               | <b>Tasks or considerations for the host subsidiary supervisor</b>                                                                                      |
|----------------------------------------------------------------------------------------------------------------------------------------------------|---------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|--------------------------------------------------------------------------------------------------------------------------------------------------------|
| <p>Consider unexpected issues identified during on-/off-site work</p> <p>Consider if unexpected issues require revisions to the original plan.</p> | <ul style="list-style-type: none"> <li>• Communicate on a timely basis to other supervisors to whom such issues may be relevant.</li> <li>• Lead a review of the issue and consider implications if the issue is related to centralised functions.</li> </ul> | <ul style="list-style-type: none"> <li>• Communicate on a timely basis to the consolidating supervisor if these issues are deemed relevant.</li> </ul> |
| <p>Complete tasks</p>                                                                                                                              | <ul style="list-style-type: none"> <li>• Collate the findings based on the consolidating supervisor's own work and input from host supervisors of significant subsidiaries.</li> </ul>                                                                        | <ul style="list-style-type: none"> <li>• Communicate key findings to the consolidating supervisor in accordance with the agreed plan.</li> </ul>       |
| <p>Discuss the implications of the on-site and off-site work performed</p>                                                                         | <ul style="list-style-type: none"> <li>• Initiate discussions with the relevant host supervisors of significant subsidiary as to the conclusions that can be drawn from the findings.</li> </ul>                                                              | <ul style="list-style-type: none"> <li>• Enter discussions with the consolidating supervisor if the issue is deemed relevant.</li> </ul>               |

#### 54. Step 5 – Evaluation

Following completion of on-site and off-site work, the supervisors will determine their supervisory programme for the group and individual subsidiaries. The consolidating supervisor is responsible for defining the programme at a consolidated level, and host subsidiary supervisors are responsible for defining the programme at the subsidiaries' level. These programmes will include any remedial action that has to be undertaken, any reporting requirements, and any follow-up procedures planned by supervisors.

| <b>Cross-border implications</b>                                             | <b>Tasks or considerations for the consolidating supervisor</b>                                                                                                                                                          | <b>Tasks or considerations for the host subsidiary supervisor</b>                                                              |
|------------------------------------------------------------------------------|--------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|--------------------------------------------------------------------------------------------------------------------------------|
| Communicate supervisory response to findings, proportionate to significance. | <ul style="list-style-type: none"> <li>Initiate an information process with host supervisors of significant subsidiaries, to identify opportunities for coordinating their respective supervisory programmes.</li> </ul> | <ul style="list-style-type: none"> <li>Communicate proposed supervisory programmes to the consolidating supervisor.</li> </ul> |
| Plan and coordinate the overall supervisory programme:<br>As in step 3       | <ul style="list-style-type: none"> <li>As in step 3.</li> </ul>                                                                                                                                                          | <ul style="list-style-type: none"> <li>As in step 3.</li> </ul>                                                                |

#### 55. Step 6 – ongoing supervision

The consolidating supervisor and host subsidiary supervisors will monitor progress on achieving the agreed goals of the supervisory programmes and on responding to any other issues in the process of day-to-day supervision.

| <b>Cross-border implications</b>               | <b>Tasks or considerations for the consolidating supervisor</b>                                                                                                        | <b>Tasks or considerations for the host subsidiary supervisor</b>                                                                             |
|------------------------------------------------|------------------------------------------------------------------------------------------------------------------------------------------------------------------------|-----------------------------------------------------------------------------------------------------------------------------------------------|
| Matters arising from the supervisory programme | <ul style="list-style-type: none"> <li>Communicate to host supervisors of significant subsidiary if the matter is relevant to their supervisory objectives.</li> </ul> | <ul style="list-style-type: none"> <li>Consult consolidating supervisor if the matter is relevant to their supervisory objectives.</li> </ul> |
| Obligations to                                 | <ul style="list-style-type: none"> <li>Communicate any</li> </ul>                                                                                                      | <ul style="list-style-type: none"> <li>Communicate any</li> </ul>                                                                             |

|                                                                                            |                                                                                                                                                                                                                                                                              |                                                          |
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| <p>other supervisors (e.g. if issues arise that are of relevance to other supervisors)</p> | <p>relevant matters to the affected host supervisors of significant subsidiary.</p> <ul style="list-style-type: none"> <li>Disseminate any information that has been communicated by host supervisors of significant subsidiaries that may be relevant to others.</li> </ul> | <p>relevant matters to the consolidating supervisor.</p> |
|--------------------------------------------------------------------------------------------|------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|----------------------------------------------------------|

***Practical framework (group and branches)***

56. The relationship between the consolidating supervisor and host branch supervisors should aim at ensuring a free exchange of information.
57. The legal obligations of host branch supervisors differ from those of host subsidiary supervisors. These obligations need to be respected at all times. Taking fully into account the allocation of responsibilities between host branch supervisors and the consolidating supervisor (or the home supervisor of the foreign branch, when it is not at the same time the consolidating supervisor), the consolidating supervisor should nevertheless take into account the benefits that the proximity of host branch supervisors in the case of systemically relevant branches could bring to each stage of the risk assessment. Especially for systemically relevant branches, a more active involvement of the relevant host supervisors in the supervisory process – in full respect of the consolidating supervisors responsibility – might help the latter in ensuring effective supervision over these branch(es) and enhance awareness with both supervisors of the local market’s exposure to its (their) financial situation. Given the legal allocation of responsibilities, the intervention of host branch supervisors can only pertain to the conventional performance of specific tasks normally entrusted to the consolidating supervisor on explicit demand of the latter; his intervention should never entail any additional burden on the group or the entity concerned.<sup>46</sup>
58. The following tables identify additional cross-border issues specific to branches which can arise at each step in a generic risk assessment. The steps are intended as general guidelines that can be adapted by competent authorities on a case-by-case basis according to the practical needs of co-operation between the parties.

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<sup>46</sup> See also Para 38 above.

59. Step 1 – initiation of process

| Cross-border implications                                                                             | Tasks or considerations for the consolidating supervisor                                                                                                                                                                                                                                                                                                                                                                 | Tasks or considerations for the host supervisor of systemically relevant branches                                                                                                                                                                                                                                                                         |
|-------------------------------------------------------------------------------------------------------|--------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|-----------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| Agreement on systemically relevant branches in the group.                                             | <ul style="list-style-type: none"> <li>• Identify systemically relevant branches for the purpose of consolidated supervision, and consult with the respective host supervisors on that decision.</li> <li>• Consult host branch supervisors on the relative systemic importance of branches.</li> <li>• Agree on systemic importance of branches with the host supervisors of systemically relevant branches.</li> </ul> | <ul style="list-style-type: none"> <li>• Inform the consolidating supervisor whether the branch is considered systemically relevant and the criterion for the assessment of systemic importance. Be prepared to discuss and justify their determination.</li> <li>• Agree on systemically relevant branches with the consolidating supervisor.</li> </ul> |
| Establish a communication strategy with the host branch supervisors of systemically relevant branches | <ul style="list-style-type: none"> <li>• Establish a communication strategy with the host supervisors of systemically relevant branches, which should call on the expertise and the proximity advantage of the host branch supervisors.</li> </ul>                                                                                                                                                                       | <ul style="list-style-type: none"> <li>• Agree on the communication strategy in consultation with the consolidating supervisor.</li> </ul>                                                                                                                                                                                                                |

60. Step 2 – risk identification and assessment

| Cross-border implications                                                                      | Tasks or considerations for the consolidating supervisor                                                                                                                   | Tasks or considerations for the host supervisor of systemically relevant branches                                                                                                                           |
|------------------------------------------------------------------------------------------------|----------------------------------------------------------------------------------------------------------------------------------------------------------------------------|-------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| Consolidating supervisor and host branch supervisors need to fully understand the risks of the | <ul style="list-style-type: none"> <li>• Produce a composite picture of the group based on the consolidating supervisor's own knowledge and input from the host</li> </ul> | <ul style="list-style-type: none"> <li>• Communicate to the consolidating supervisor if requested: <ul style="list-style-type: none"> <li>- assessments of market developments which</li> </ul> </li> </ul> |

|                                                                                                                 |                                                                                                                                                                                                                                                                                                                                                         |                                                                                                                                                                   |
|-----------------------------------------------------------------------------------------------------------------|---------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|-------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| <p>group and its branches.</p> <p>Information gaps in individual supervisors' knowledge need to be plugged.</p> | <p>supervisors of systemically relevant branches.</p> <ul style="list-style-type: none"> <li>• Communicate an overall assessment of the group and of centralised operations to hosts supervisors of systemically relevant branches. The extent of the assessment communicated will vary depending upon the systemic relevance of the branch.</li> </ul> | <p>might influence the group;</p> <ul style="list-style-type: none"> <li>- the branch assessment derived from liquidity and other statutory reporting.</li> </ul> |
|-----------------------------------------------------------------------------------------------------------------|---------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|-------------------------------------------------------------------------------------------------------------------------------------------------------------------|

*61. Step 3 – planning supervisory action*

| <b>Cross-border implications</b>                                           | <b>Tasks or considerations for the consolidating supervisor</b>                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                              | <b>Tasks or considerations for the host supervisor of systemically relevant branches</b>                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                |
|----------------------------------------------------------------------------|--------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|---------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| <p>Possible allocation of supervisory tasks to host branch supervisors</p> | <ul style="list-style-type: none"> <li>• Consider in the interest of effectiveness and efficiency the possibility of asking the host supervisors of systemically relevant branches to undertake work or provide assistance in supervising branches.</li> <li>• Discuss whether work might be undertaken by the host supervisor of systemically relevant branches. The consolidating supervisor (or the home supervisor of the foreign branch, when it is not at the same time the consolidating supervisor) retains responsibility for planning and seeks to ensure that work is performed to its</li> </ul> | <ul style="list-style-type: none"> <li>• Consider whether to undertake work on behalf of the consolidating supervisor (or the home supervisor of the foreign branch, when it is not at the same time the consolidating supervisor) with respect to branches if requested. The host supervisor of systemically relevant branches: <ul style="list-style-type: none"> <li>- assumes no statutory responsibilities as a result of its assistance; and</li> <li>- performs no work on its own initiative except where permitted within its own statutory remit (e.g. with respect to</li> </ul> </li> </ul> |

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|  | satisfaction. | liquidity). |
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62. Step 4 – performing supervisory tasks

| <b>Cross-border implications</b> | <b>Tasks or considerations for the consolidating supervisor</b>                                                                                                                                                                                          | <b>Tasks or considerations for the host supervisor of systemically relevant branches</b>                                                                                               |
|----------------------------------|----------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|----------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| Completion of tasks              | <ul style="list-style-type: none"> <li>• Collate the findings of the host supervisor of systemically relevant branches, and draw conclusions.</li> <li>• Share findings of work with the host supervisor of the systemically relevant branch.</li> </ul> | <ul style="list-style-type: none"> <li>• Report the findings of any tasks to the consolidating supervisor on a timely basis and in accordance with any agreed instructions.</li> </ul> |
| Reporting of conclusions         | <ul style="list-style-type: none"> <li>• Report significant conclusions to the host supervisors of systemically relevant branches.</li> </ul>                                                                                                            |                                                                                                                                                                                        |

63. Step 5 – Evaluation

| <b>Cross-border implications</b> | <b>Tasks or considerations for the consolidating supervisor</b>                                                                                                                                                         | <b>Tasks or considerations for the host supervisor of systemically relevant branches</b> |
|----------------------------------|-------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|------------------------------------------------------------------------------------------|
| Further work in the branch       | <ul style="list-style-type: none"> <li>• Communicate to the host supervisor of systemically relevant branches if further work is planned for the specific branch. Any further work would then follow step 3.</li> </ul> |                                                                                          |

64. Step 6 – ongoing supervision

| <b>Cross-border implications</b> | <b>Tasks or considerations for the consolidating supervisor</b>            | <b>Tasks or considerations for the host supervisor of systemically relevant branches</b> |
|----------------------------------|----------------------------------------------------------------------------|------------------------------------------------------------------------------------------|
| On going                         | <ul style="list-style-type: none"> <li>• Report any significant</li> </ul> | <ul style="list-style-type: none"> <li>• Report any matters that</li> </ul>              |

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| <p>obligations of supervisors (predominately in the area of information exchange).</p> | <p>matters that arise during the ongoing supervision of the branch that may be relevant to a host supervisor of systemically relevant branches.</p> <ul style="list-style-type: none"> <li>• With regard to the extended exchange of information the consolidating supervisor should plan, coordinate, and organise supervisory action and communicate its determinations regularly to the host supervisors of systemically relevant branches.</li> </ul> | <p>come to its attention that may be relevant to the consolidating supervisor's supervision of the branch.</p> |
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### ***Practical framework (model approval)<sup>47</sup>***

65. Article 129(2) of the [Directive 2006/48/EC](#) introduces a specific requirement that supervisors must work together to determine whether or not to grant permission to a group to use its internal rating systems (IRB) or operational risk measurement systems (AMA) for regulatory purposes, when the group has submitted a single application covering both the consolidated and solo requirements of the group.<sup>48</sup>
66. In view of this legal requirement, this specific section on the pre-application, approval and post-approval process elaborates upon the general guidance given in the following areas:
- the specific steps in the approval process;
  - the explicit requirement for a formal consultative process;
  - time limits in which this process should lead to a common decision;

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<sup>47</sup> This part is taken from CEBS Guidelines on the Model Validation.

<sup>48</sup> Article 129(2) of the Directive 2006/48/EC governs not only applications to use the IRB and AMA estimates but also applications to use own estimates of Effective Expected Positive Exposure (Effective EPE) for measuring counterparty exposure on OTC derivative contracts, securities financing transactions and long settlements transactions. Moreover, according to Directive 2006/49/EC (Article 37(2) of the Directive 2006/49/EC), Article 129(2) of the Directive 2006/48/EC also applies to institutions applying for the use of Value at Risk (VaR) models for market risk. These guidelines discuss Article 129(2) of the Directive 2006/48/EC as it concerns IRB and AMA applications but not Effective EPE or market risk model applications.

- the specific role of the consolidating supervisor in this consultation period.
67. The new legal requirements relating to the approval process neither justify nor require any departure from the general guidance for supervisory co-operation on a cross-border basis. The general principles set out above remain therefore valid and relevant for supervisory co-operation on the approval process.
  68. To facilitate a common decision within the six-month period specified in Article 129(2) of the [Directive 2006/48/EC](#) supervisors have agreed on a common understanding on the pre-application, the approval and the post-approval phase.
  69. A group may enter into exploratory discussions with the consolidating or host supervisors about the use of internal models for all or parts of its business. While there is no formal requirement to do so, supervisors are expected to communicate the outcome of these discussions to other relevant supervisors; and to inform the group of the nature of the approval framework and that applications will be coordinated through the consolidating supervisor.
  70. However, as soon as a group expresses a clear intention to move towards the advanced approaches, even before an application is made, it is essential that the pre-application process be centralised with the consolidating supervisor, acting as the coordinator and the central point of contact for the group.
  71. Supervisors have a relatively tight timeframe of six months after receipt of a complete formal application in which to reach a decision on the approval. The pre-application period thus becomes an important step in ensuring that the approval process for both the group and its supervisors is conducted in an efficient, coordinated and effective manner.
  72. During this pre-application period it is essential that:
    - i. supervisors understand the extent and nature of the intended use of internal rating and operational risk management systems (for example: which risks, entities and exposures are to be covered; how internal models are being rolled out across the group, governance and risk management arrangements, data collection and management, and testing);
    - ii. all supervisors concerned be consulted to establish a co-operative and consultative framework. This framework needs to encompass the following:
      - which supervisors are to be involved, their respective roles and responsibilities, and the allocation of specific tasks;
      - a communication strategy and escalation process; and
      - procedures to ensure, that a consensus can be reached among supervisors;

- iii. supervisors develop an overall supervisory plan of action that covers each of the steps in the approval process and that includes priority issues and a timetable;
  - iv. the group familiarises itself with the approval framework and the requirements and standards concerning the information that it will need to submit;<sup>49</sup>
  - v. there is early identification and communication of any specific group or local concerns or issues that need to be factored into the process;
  - vi. supervisors seek to identify potential areas of disagreement;
  - vii. supervisors agree, after due consultation with the group, on the format and timescale for the submission of the formal application and the planning of the assessment to be undertaken by supervisors;<sup>50</sup>
  - viii. supervisors agree on the way that the eventual implementation of the rating and operational risk measurement systems will be structured and monitored.<sup>51</sup>
73. Responsibility for organising and coordinating these pre-application tasks, and more generally for the overall approval process, shall reside with the consolidating supervisor. This responsibility cannot be delegated to another supervisor, although certain tasks – including practical coordinating aspects – may be allocated to other supervisors involved. Thus, for example, while it is expected that the consolidating supervisor will lead the assessment of centrally developed models and the assessment of the group's governance and centralised risk management functions, host supervisors could lead the assessment of locally developed models and local implementation of centrally developed models. The effective coordination of practical work on specific models (e.g. for certain business lines) can, under the responsibility of the consolidating supervisor, be entrusted to the supervisor best placed to ensure the efficient running of the process. This can also apply to centrally developed aspects of the models.
74. Consolidating supervisors should liaise with host branch supervisors of systemically relevant branches to determine the extent to which the latter can contribute to the efficiency of the process. For example, by virtue of their proximity host branch supervisors can offer valuable insights into the impact of local market conditions on models, or can assist in the assessment of data. This is not intended to add additional responsibilities for branch supervisors, but rather to ensure that the process takes maximum advantage of local knowledge.

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<sup>49</sup> For more details on the information to be submitted see Section 2.2. of the CEBS Guidelines on Model Validation.

<sup>50</sup> See Section 2.2.1. of the CEBS Guidelines on Model Validation for details on format and timeframe of applications. Additional information on the assessment of applications can be found in Section 2.2.2. of the CEBS Guidelines on Model Validation.

<sup>51</sup> Section 2.2.5. of the CEBS Guidelines on Model Validation provides details on the post-approval process

75. Special attention should be given to ensuring that information is exchanged upon receipt of a formal application and to coordinating work on assessing the completeness of the application.
76. Upon reaching a decision, the consolidating supervisor shall coordinate the drafting of a communication in which the supervisory decision is duly documented in accordance with Article 129(2) of the [Directive 2006/48/EC](#). The consolidating supervisor should seek an appropriate procedure for formalizing the adherence of all concerned supervisors to the decision.<sup>52</sup>
77. The CRD specifies that the consolidating supervisor shall make the final determination in the event that supervisors cannot reach a consensus. This is regarded as an exceptional circumstance. Supervisors should try to avoid this outcome by identifying potential areas of disagreement early in the process and prioritising them for early discussion.
- 78a. Supervisors will also ensure adequate communication with the banking group through an on-going dialogue.
78. Those steps are designed as general guidelines that can be adapted by competent authorities on a case-by-case basis according to the concrete needs of co-operation between the parties.

*79. Step 1 – Pre-application*

| Cross-border implications                                                                  | Tasks or considerations for the consolidating supervisor                                                                                                                                                                               | Tasks or considerations for the host supervisor                                                                                                                                                                               |
|--------------------------------------------------------------------------------------------|----------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|-------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| The group has exploratory discussions with individual supervisors about the use of models. | <ul style="list-style-type: none"> <li>There is no formal requirement that other supervisors need be informed at this stage. However, supervisors are advised to communicate the outcomes of their exploratory discussions.</li> </ul> | <ul style="list-style-type: none"> <li>There is no expectation that other supervisors need be informed at this stage, though, at a minimum, informal contact with the consolidating supervisor would be advisable.</li> </ul> |
| The group expresses a clear intention to move towards the advanced approaches.             | <ul style="list-style-type: none"> <li>The consolidating supervisors should advise the relevant host supervisors.</li> </ul>                                                                                                           | <ul style="list-style-type: none"> <li>Inform the consolidating supervisor that local institutions are contemplating the use of internal models.</li> </ul>                                                                   |
| Consultative framework.                                                                    | <ul style="list-style-type: none"> <li>Plan and organise a consultative framework to include:</li> </ul>                                                                                                                               |                                                                                                                                                                                                                               |

<sup>52</sup> For more details concerning the decision see Section 2.2.3. of the CEBS Guidelines on Model Validation.

|                                                                |                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                |                                                                                                                                                                                                                            |
|----------------------------------------------------------------|----------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|----------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
|                                                                | <ul style="list-style-type: none"> <li>- a communication strategy for all supervisors; and</li> <li>- a mechanism enhancing a common agreement among supervisors.</li> </ul>                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                   |                                                                                                                                                                                                                            |
| Understanding the extent and nature of the groups' intentions. | <ul style="list-style-type: none"> <li>• Discuss with the group the intentions to implement an internal models approach.</li> <li>• Produce a preliminary assessment of the group's proposals, including: <ul style="list-style-type: none"> <li>- the readiness of the group; and</li> <li>- the adequacy of plans.</li> </ul> </li> <li>• Communicate the salient features to the supervisors likely to be affected by the group's intentions, and inform other supervisors of the group's plans in accordance with the general communication strategy.</li> <li>• Collate the concerns and issues of other supervisors with the proposed approach and produce a summary of the principal issues.</li> </ul> | <ul style="list-style-type: none"> <li>• Communicate concerns and issues with the proposed approach.</li> <li>• Need to identify potential disagreements so that supervisors can have an early plan to address.</li> </ul> |
| Supervisory plan of action.                                    | <ul style="list-style-type: none"> <li>• Draw up the supervisory plan in consultation with other relevant supervisors and in co-operation with the group. The plan should include: <ul style="list-style-type: none"> <li>- identification of significant models and proposed roll-out plans;</li> <li>- the allocation of</li> </ul> </li> </ul>                                                                                                                                                                                                                                                                                                                                                              |                                                                                                                                                                                                                            |

|  |                                                                                                                                                                                                                                                                                                                                                                                                      |  |
|--|------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|--|
|  | <p>workload with respect to the significant models;</p> <ul style="list-style-type: none"> <li>- priority issues;</li> <li>- a timetable;</li> <li>- standards by which to judge the completeness and the accuracy of the application; and</li> <li>- standards for reaching agreement on a final decision;</li> </ul> <p>➤ Communicate the salient points of the supervisory plan to the group.</p> |  |
|--|------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|--|

*80. Step 2 – Formal application*

| Cross-border implications     | Tasks or considerations for the consolidating supervisor                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                             | Tasks or considerations for the host supervisor                                                                                                                                                                                                                 |
|-------------------------------|------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|-----------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| Formal application submitted. | <ul style="list-style-type: none"> <li>• Determine promptly if the application is obviously incomplete (e.g. significant omissions of specified information): <ul style="list-style-type: none"> <li>- if so, communicate to the group that the application is incomplete, setting out the reasons why and what further information the group may need to submit;</li> <li>- inform the other supervisors that an application has been received, that it is incomplete, and that the group has been asked to provide further information.</li> </ul> </li> <li>• If not, inform the other</li> </ul> | <ul style="list-style-type: none"> <li>• Assess those aspects of the application that the host is best able to comment on (e.g. relating to locally developed models) and communicate the results of the assessment to the consolidating supervisor.</li> </ul> |

|  |                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                   |  |
|--|-------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|--|
|  | <p>supervisors promptly that an application has been received, and distribute the application form, in whole or part, as previously agreed.</p> <ul style="list-style-type: none"> <li>• Assess the completeness and accuracy of the application against pre-agreed standards and in consultation with the host supervisors with respect to local models.</li> <li>• Communicate the final results of the assessment to the group and to other supervisors: <ul style="list-style-type: none"> <li>- if the application is found to be incomplete, communicate that finding to the group, setting out the reasons why and what further information the group may need to submit;</li> <li>- if the application is complete, inform the other supervisors that the six-month period has started, and initiate the next step in the process.</li> </ul> </li> </ul> |  |
|--|-------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|--|

*81. Step 3 – Model assessment*

| Cross-border implications | Tasks or considerations for the consolidating supervisor                                                                                                  | Tasks or considerations for the host supervisor                                                                                                                         |
|---------------------------|-----------------------------------------------------------------------------------------------------------------------------------------------------------|-------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| Performing the work.      | <ul style="list-style-type: none"> <li>• Lead the assessment of centralised models and some local models (where agreed), the governance of the</li> </ul> | <ul style="list-style-type: none"> <li>• Lead the assessment of local models (where agreed), the governance of the local entities, and local risk management</li> </ul> |

|                                          |                                                                                                                                                                                                                                                                                                   |                                                                                                                                                                                                                                                                                                                                                                                                                                               |
|------------------------------------------|---------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|-----------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
|                                          | <p>group, the role of the Board and Senior Management and centralised risk management functions.</p> <ul style="list-style-type: none"> <li>• Assess compliance with the Use Test.</li> <li>• Assess self-assessment.</li> <li>• Assess the roll-out plan, if applicable.</li> </ul>              | <p>functions.</p> <ul style="list-style-type: none"> <li>• Assess compliance with the Use Test with respect to local models.</li> </ul>                                                                                                                                                                                                                                                                                                       |
| Reporting the results of work performed. | <ul style="list-style-type: none"> <li>• Collate progress reports and assess the overall level of progress.</li> <li>• Assess whether the supervisory plans need to be revised.</li> <li>• Report overall progress to host supervisors in accordance with the agreed supervisory plan.</li> </ul> | <ul style="list-style-type: none"> <li>• Provide the consolidating supervisor with progress reports on the work, in accordance with the agreed supervisory plan.</li> <li>• Inform the consolidating supervisor immediately in the event of: <ul style="list-style-type: none"> <li>- significant failings identified in the model application process;</li> <li>- if there is a risk, that deadlines will not be met.</li> </ul> </li> </ul> |

*82. Step 4 – Decision*

| Cross-border implications  | Tasks or considerations for the consolidating supervisor                                                                                                                                                                                                                     | Tasks or considerations for the host supervisor                                                                                                                                                                                                                              |
|----------------------------|------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| Agreement on the decision. | <ul style="list-style-type: none"> <li>• Agree on decisions.</li> <li>• Agree on any terms and conditions to be attached to the decision.</li> <li>• Agree on the process for handling roll-out.</li> <li>• Agree on the timeframe for implementing the decision.</li> </ul> | <ul style="list-style-type: none"> <li>• Agree on decisions.</li> <li>• Agree on any terms and conditions to be attached to the decision.</li> <li>• Agree on the process for handling roll-out.</li> <li>• Agree on the timeframe for implementing the decision.</li> </ul> |

|                            |                                                                                                                                                      |  |
|----------------------------|------------------------------------------------------------------------------------------------------------------------------------------------------|--|
| Communication of decision. | <ul style="list-style-type: none"> <li>Draw up the fully reasoned decision document in accordance with agreed principles for convergence.</li> </ul> |  |
|----------------------------|------------------------------------------------------------------------------------------------------------------------------------------------------|--|

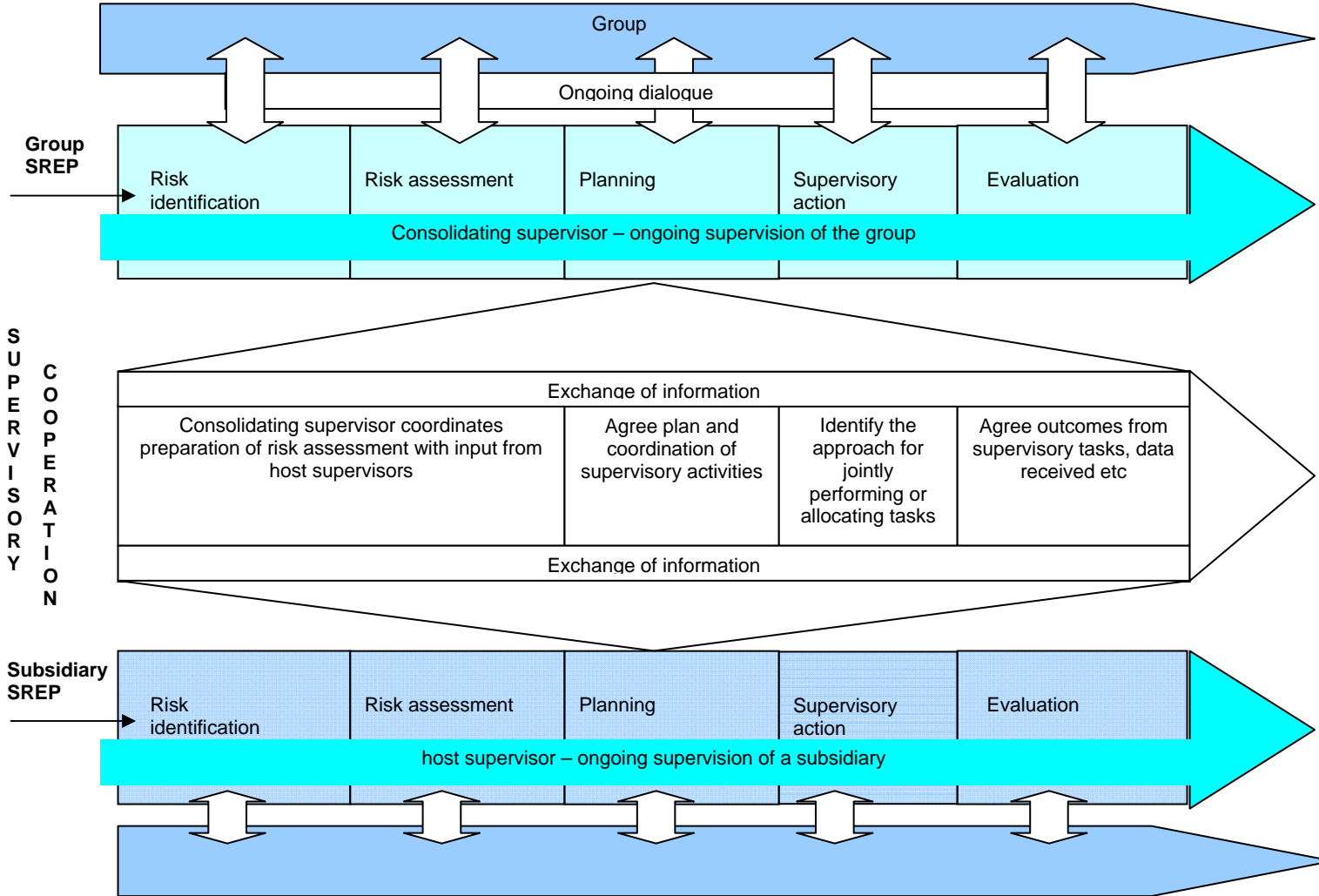
*83. Step 5 – Implementation*

|                                    |                                                                                                                   |                                                                                                                   |
|------------------------------------|-------------------------------------------------------------------------------------------------------------------|-------------------------------------------------------------------------------------------------------------------|
| Cross-border implications          | Tasks or considerations for the consolidating supervisor                                                          | Tasks or considerations for the host supervisor                                                                   |
| Implementation of decision.        | <ul style="list-style-type: none"> <li>Implement the decision in accordance with national legislation.</li> </ul> | <ul style="list-style-type: none"> <li>Implement the decision in accordance with national legislation.</li> </ul> |
| Planning, assessing and reporting. | Follow similar procedures to step 3.                                                                              | Follow similar procedures to step 3.                                                                              |

*84. Step 6 – On-going review*

The on-going review of the continuing appropriateness of the models in use shall be conducted within the Pillar 2 framework. The framework for supervisory co-operation should follow the steps outlined above.

1.7. **Appendix I –Overview of SREP**



## **IV. Guidelines on Model Validation, ECAIs and Prudential Filters**

### **Guidelines on Model Validation**

**Guidelines on the implementation, validation and assessment of Advanced Measurement (AMA) and Internal Ratings Based (IRB) Approaches<sup>53</sup>**

|                                                                                                                         |     |
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<sup>53</sup> As to the history of this guidelines on the implementation, validation and assessment of Advanced Measurement (AMA) and Internal Ratings Based (IRB) Approaches, please find the link to the CEBS website: <http://www.cebs.org/documents/Publications/Standards--Guidelines/files-from-old-website/GL10.aspx>

## List of acronyms:

|                     |                                                  |
|---------------------|--------------------------------------------------|
| <b>AIG</b>          | <b>Accord Implementation Group</b>               |
| <b>AMA</b>          | <b>Advanced Measurement Approach</b>             |
| <b>ASA</b>          | <b>Alternative Standardised Approach</b>         |
| <b>BCBS</b>         | <b>Basel Committee on Banking Supervision</b>    |
| <b>BE</b>           | <b>Business Environment</b>                      |
| <b>BIA</b>          | <b>Basic Indicator Approach</b>                  |
| <b>BL</b>           | <b>Business Line</b>                             |
| <b>CEBS</b>         | <b>Committee of European Banking Supervisors</b> |
| <b>CF</b>           | <b>Conversion Factors</b>                        |
| <b>CRCF</b>         | <b>Credit Risk Control Function</b>              |
| <b>CRCU</b>         | <b>Credit Risk Control Unit</b>                  |
| <b>CRD</b>          | <b>Capital Requirements Directive</b>            |
| <b>EL</b>           | <b>Expected Loss</b>                             |
| <b>ECAI</b>         | <b>External Credit Assessment Institution</b>    |
| <b>HVCRE</b>        | <b>High Volatility Commercial Real Estate</b>    |
| <b>ICF</b>          | <b>Internal control factors</b>                  |
| <b>IRB Approach</b> | <b>Internal Ratings Based Approach</b>           |
| <b>KRI</b>          | <b>Key risk indicators</b>                       |
| <b>LDA</b>          | <b>Loss distribution approach</b>                |
| <b>LGD</b>          | <b>Loss Given Default</b>                        |
| <b>LTV</b>          | <b>Loan-to-value</b>                             |
| <b>ORMF</b>         | <b>Operational Risk Management Function</b>      |
| <b>PD</b>           | <b>Probability of Default</b>                    |

|            |                                        |
|------------|----------------------------------------|
| <b>RDS</b> | <b>Reference Data Set</b>              |
| <b>SBA</b> | <b>Scenario based approach</b>         |
| <b>SL</b>  | <b>Specialised Lending</b>             |
| <b>SME</b> | <b>Small and Medium Sized Entities</b> |
| <b>TSA</b> | <b>The Standardised Approach</b>       |
| <b>UL</b>  | <b>Unexpected Loss</b>                 |

## Executive summary

1. These guidelines reflect a common understanding among European supervisory authorities on the procedures to be used in processing, assessing, and making decisions on the application of an institution to use an Advanced Measurement (AMA) or an Internal Ratings Based (IRB) approach for regulatory purposes. It also sets out guidance, again based on a common understanding among the supervisory authorities, on the meaning and the implementation of the minimum requirements for using these approaches, as set out in the Capital Requirements Directive (CRD)<sup>54</sup>.
2. The CRD requires an explicit approval process for the use of AMA and IRB approaches for regulatory purposes. Approval to use an IRB approach can be given only if the competent authority is satisfied that the institution's systems for managing and rating credit risk exposures are sound and implemented with integrity and, in particular, that they meet the requirements listed in Article 84 in accordance with Annex VII, Part 4 of the [Directive 2006/48/EC](#). Similarly, approval to use an AMA under Article 105 can be given only when institutions satisfy their competent authorities that they meet the qualifying criteria set out in Annex X, Part 3 of the [Directive 2006/48/EC](#).
3. One of the greatest challenges for supervisors in implementing the CRD is defining under what conditions they will be satisfied with these systems. Supervisors would like these conditions to be convergent across the EU member states, in order to make the playing field as level as possible for institutions using AMA and IRB approaches.
4. These guidelines represent CEBS' current thinking on the implementation, validation, and assessment of the AMA and IRB approaches, based on supervisory experience and expectations for these approaches as of the beginning of 2006. The guidelines cover a wide range of topics, including the definition of loss and default; requirements for rating obligors and exposures; the estimation and validation of internal risk parameters (including 'downturn LGDs'); corporate governance matters; data issues; technical aspects of AMA (including expected loss); allocation mechanisms; and the application, assessment, and decision processes. Evolving industry practices and the practical application of these guidelines will enlarge supervisors' experience. As supervisors will gain experience in the course of their examination and decision processes, it could turn out

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<sup>54</sup> Except where noted otherwise, all references to Articles of the CRD are references to the Directive 2006/48/EC.

that certain elements of the guidelines may not stand the test of time (e.g. unexpected side effects). Supervisors may reflect such additional information for the interpretation of these guidelines. They will be subject to review following implementation of the CRD, when and where necessary ('maintenance'). For example, both industry and regulators are still developing their thinking on how insurance and other risk transfer mechanisms should be taken into account in an AMA framework. Accordingly, for the time being, CEBS has not provided much guidance on this issue. However, CEBS expects that dialogue on the use of insurance and other risk transfer mechanisms will continue.

5. These guidelines are drafted as guidance to supervisors, elaborating on the CRD Articles and Annexes. However, since the guidelines express CEBS' expectations of how national supervisory authorities should deal with the implementation and assessment of AMA and IRB approaches, they clearly also affect the institutions that intend to use these approaches. In interpreting the guidelines, institutions have to distinguish between two types of cases. In cases where the guidelines reflect a common understanding among national supervisors on what they should expect from their institutions, the text discusses what institutions "should" do. In all other cases (apart from direct quotes of the CRD) – e.g., institutions "could," "may," etc. – the guidelines simply provide illustrative examples, meaning that institutions are free to use other solutions that meet or exceed the supervisors' requirements, unless national supervisors have issued specific guidance to the contrary. In cases where the CRD is quoted, the text of these guidelines uses "shall."
6. The guidelines will be a helpful tool for national supervisors (on-site examiners and off-site inspectors), both in assessing applications to use an AMA or IRB approach, and in subsequent examinations or inspections of the approaches applied. The guidelines will also reduce the burden on the industry. In particular, they will streamline the application and decision process under Article 129(2) of the [Directive 2006/48/EC](#). To assist in assessing whether an application is complete, the supervisors have agreed on a minimum set of documents to be included in applications, while still leaving each authority the right to require additional documents. Similarly, the guidelines contain a list of areas that the assessment of applications would concentrate on. The guidelines should therefore simplify and speed up the approval process.
7. These guidelines do not cover 'explicit' national discretions: that is, areas where the CRD presents the competent supervisory authority with an explicit choice of alternatives to apply. This topic has already been addressed by CEBS in the 'national discretions' exercise. For example, no guidance has been given on how supervisory authorities should make use of the explicit discretion on the number of days

past due for retail and Public Sector Entities exposures.<sup>55</sup>

8. The guidelines cover a broader concept of validation than that used by the Validation Sub-Group of the Basel Committee's Accord Implementation Group (AIG), since assessing the institution's validation of its internal rating systems (IRB) and its operational risk measurement systems (AMA) is only part of the much broader concept of a supervisor's assessment. This difference in focus does not, however, imply any inconsistency with the work of the AIG. To the contrary, consistency with the work of the AIG sub-groups on validation and data issues and the AIG Sub-Group on Operational Risk was one of the prior goals in drafting these guidelines. Indeed, these guidelines adopt the High-Level Principles on Validation of the AIG Sub-Group on Validation and use them as the basis for elaborating further guidance on this subject. Similarly, the guidance provided on downturn LGDs is based on the Basel Committee's "Guidance on Paragraph 468 of the Framework document" and the paragraphs on expected loss in section 4.3.4.4. reflect the work done by the AIG Sub-Group on Operational Risk.
- 8a. In general, the good faith of institutions that have developed systems and procedures prior to the publication of CP10 on the basis of a dialogue with their national supervisors should be respected. Thus supervisors may refrain from applying certain provisions of sections 3 and 4 of these guidelines for a limited and appropriate period of time, in order to allow these institutions to change their systems and plan future enhancements in an orderly way. This also applies to cross-border groups and/or their subsidiaries.
9. These Guidelines have been unanimously endorsed by CEBS Members in the spirit of further converging supervisory practices within the EU and in accordance with CEBS statement on the character of its publications. In developing the guidelines, CEBS has benefited from ongoing dialogue and meetings with industry experts and the guidelines went through two rounds of public consultation. The comments received from the industry have been published on the CEBS website unless the respondents requested otherwise. CEBS Feedback on the industry responses received has been published in a separate document respectively (see [CP10 feedback](#) and [CP10r feedback](#) )

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<sup>55</sup> The national supervisory authorities will disclose how they make use of the discretions granted to them by the CRD and what guidance they give on the implementation, validation, and assessment of the AMA and IRB approaches. (For more detailed information on this point, see CEBS Guidelines on the Common Supervisory Disclosure Framework)

## 1. Introduction

### 1.1. Why guidelines at all, and why now?

10. The New Basel Accord <sup>56</sup> (Basel II) adopted by the Basel Committee on Banking Supervision (BCBS) in June 2004, and the Capital Requirements Directive (CRD), allow institutions to calculate their capital requirements for credit risk and operational risk using methods that are significantly more risk-sensitive than those set forth in the original 1988 Basel Accord (Basel I). The most sophisticated approaches permitted in the new texts – the Internal Ratings Based (IRB) Approach for credit risk and the Advanced Measurement Approach (AMA) for operational risk – allow institutions to use their own estimates of risk parameters such as the probability of default (PD) of an obligor. IRB parameters are inserted into supervisory formulas which are used to calculate the institution's capital requirements, while AMA parameters are fed into models developed by the institution itself.
11. The adequacy of the resulting capital requirements depends critically on the adequacy of the estimated risk parameters and – in the case of the AMA – on the soundness of the AMA models used.
12. Accordingly, the CRD requires explicit supervisory approval for the use of the AMA and IRB approaches for regulatory purposes. The relevant principles and more technical requirements are set out in the CRD Articles and Annexes respectively. Approval to use the IRB approach can be given only if the competent authority is satisfied that the institution's systems for managing and rating credit risk exposures are sound, are implemented with integrity, and meet the requirements listed in Article 84 and Annex VII, Part 4 of the Directive 2006/48/EC. Approval to use the AMA approach can be given only if the competent authority is satisfied that the institution's systems for measuring operational risk meet the qualifying criteria in Annex X, Part 3 of the Directive 2006/48/EC.
13. One of the greatest challenges for supervisors in implementing the CRD is defining the conditions under which they will be satisfied with these systems. Ideally, the conditions should be convergent across EU member states, in order to make the playing field as level as possible for institutions using the AMA and IRB approaches.

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<sup>56</sup> International Convergence of Capital Measurement and Capital Standards – A Revised Framework, Basel Committee on Banking Supervision, June 2004 (<http://www.bis.org/publ/bcbs107.htm>) (as updated in November 2005, now containing also the Committee's 18 July 2005 paper on the application of Basel II to trading activities and the treatment of double default effects (<http://www.bis.org/publ/bcbs116.htm>))

14. CEBS chose to publish the first version of these guidelines for consultation while the European institutions were still debating the final form and details of the CRD. In the meantime, both the European Parliament and the EU Council have adopted the CRD. Some amendments on technical details made it necessary to change the text of CP10. However, given the short amount of time remaining for national implementation, any further delay in the first consultation would have made it impossible for CEBS to influence national implementation, which is one of CEBS' key tasks. CEBS' goal is to reduce inconsistency in implementation and supervisory practices that are within the competence of the supervisory authorities, while respecting the need for flexibility and supervisory judgement and respecting national diversity. By promoting a consistent approach to supervision across the EU, and by promulgating best practices in banking supervision and risk management, CEBS will contribute to enhancing the effectiveness and efficiency of bank supervision, ensuring a level playing field, and promoting the competitive standing of the EU banking sector. The new capital regime offers an unprecedented opportunity to make progress in these areas, because it implies a new approach to supervision for all EU supervisory authorities.
- 14a. In general, the good faith of institutions that have developed systems and procedures prior to the publication of CP10 on the basis of a dialogue with their national supervisors should be respected. Thus supervisors may refrain from applying certain provisions of sections 3 and 4 of these guidelines for a limited and appropriate period of time in order to allow these institutions to change their systems and plan future enhancements in an orderly way. This also applies to cross-border groups and/or their subsidiaries.
- 14b. These guidelines reflect supervisory experience and expectations for the AMA and IRB approaches as of the beginning of 2006. Since evolving industry practices and the practical application of these guidelines will enlarge supervisors' experience, in particular with respect to the AMA, these guidelines will be subject to review an appropriate period of time after CRD implementation and application ('maintenance').

## **1.2. What is covered and what is not?**

15. The guidelines are intended to support the work of national supervisors when dealing with a model application. They cover a considerable range of topics concerning the application, decision, and especially the assessment process, sometimes in a considerable detail.

- 15a. The guidelines do not make any reference to possible arrangements between EU and non-EU supervisors. If future negotiations between EU and non-EU countries on banking supervision make this possible, CEBS would extend the guidelines correspondingly. If requested, CEBS could contribute to these discussions.
16. The guidelines relate primarily to the AMA and IRB Approaches. They do not provide any guidance on the Standardised Approach for Credit Risk. They do, however, provide some guidance on the Basic Indicator Approach and The Standardised Approaches for operational risk.
- 17.
18. The guidelines do not contain detailed requirements relating to IT systems architecture, contingency plans, data integrity, or physical security. The relevance of these topics goes well beyond the calculation of regulatory capital requirements. It was not considered necessary to address these issues in detail in guidelines that focus specifically on AMA and IRB matters. While the guidelines do contain some references to basic principles in these areas, it is expected that supervisors will consider them as part of their broader assessment of the institution's overall control structure.

### **1.3. Addressees/Scope of application**

19. These guidelines are drafted as guidance to supervisors, elaborating on the CRD Articles and Annexes. However, since the guidelines express CEBS' expectations on how national supervisory authorities should deal with the implementation and assessment of AMA and IRB approaches, they clearly also affect the institutions using these approaches.
- 19a. In interpreting the guidelines, institutions have to distinguish between two types of cases. In cases where the guidelines reflect a common understanding among the national supervisors on what they should expect from their institutions, the text discusses what institutions "should" do. In all other cases (apart from direct quotes of the CRD) – e.g., institutions "could," "may," etc. – the guidelines simply provide illustrative examples, meaning that institutions are free to use other solutions that meet or exceed supervisors' requirements, unless national supervisors have issued specific guidance to the contrary. In cases where the CRD is quoted, the text of these guidelines uses "shall."
20. Article 20 of [Directive 2006/49/EC](#) – like the version of 93/6/EEC it replaced – extends the credit risk and operational risk capital requirements of [Directive 2006/48/EC](#) to investment firms. While the requirements for credit institutions and investment firms are not

completely identical (for operational risk, there are significant modifications to take account of the specific features of the investment firm sector, with an option to continue the 'Expenditure Based Requirement' for investment firms falling into the low, medium, and medium/high-risk categories), such differences are the exception rather than the rule. Accordingly, the guidelines use the term 'institutions' (referring to both credit institutions and investment firms) rather than 'credit institutions,' although the latter is the official term used in the Directive 2006/48/EC.

21. In order to maintain a level playing field, these guidelines apply not only to large cross-border groups, but also to all other institutions. It is expected, however, that national supervisory authorities will take the principle of proportionality (proportional to the nature, size, scale, and complexity of the institution) into account. Supervisors should bear in mind, however, that even smaller and less complex institutions that have chosen to apply for the use of the AMA or IRB approaches for regulatory purposes have, by doing so, made the choice of complying with the minimum requirements for these approaches. In assessing compliance, supervisors should use the principle of proportionality in the sense that they would expect institutions to have risk measurement and management systems whose complexity is commensurate with the complexity of their operations/business.
22. These guidelines are neutral on the extent to which supervisors perform their own assessments. This choice will reflect the different approaches of individual national authorities regarding the use of external auditors or internal inspectors for on-site missions or off-site assessments.
23. In line with CEBS' mandate and reflecting the nature of its consensus-based tools for promoting convergence, these guidelines reflect a common understanding among European supervisory authorities on the procedures to be used in processing, assessing, and making decisions on the application of an institution to use an AMA or an IRB approach for regulatory purposes. They also set out guidance, again based on a common understanding among the supervisory authorities, on the meaning and the implementation of the minimum requirements for using these approaches, as set out in the CRD.
- 23a. These guidelines are neither comprehensive nor exhaustive. Supervisors may impose stronger or more detailed requirements than those listed in the guidelines. This reflects the nature of the document on which guidance is being given: the Capital Requirements *Directive* (not *regulation*). In transposing a Directive, member states are free to impose stricter requirements than those set out in the Directive. No institution should therefore conclude that national supervisors are prohibited from imposing additional

requirements in a given area simply because it is not covered by the CEBS guidelines.

24. Although supervisory authorities could encourage institutions to move to advanced approaches for calculating all their capital requirements, there is no specific requirement in the CRD for the synchronised use of AMA and IRB Approaches. An institution that adopts an advanced approach for credit risk is not obliged to move to an advanced approach for operational risk, or vice versa. This is ultimately a decision for the institution to make on the basis of specific operational or credit risk elements and variables.

#### **1.4. Contents of the guidelines**

25. The first part of the guidelines (section 2 of this paper) describes the supervisory cooperation process and sets out minimum requirements governing the application to use an AMA or an IRB approach, the supervisor's assessment of the application, and the supervisor's decision.
26. The second part of the guidelines (section 3 of this paper) expands on the minimum requirements of the CRD, which institutions must fulfil in order to use an IRB approach for regulatory purposes. These minimum requirements relate to:
  - The methodology used for assigning ratings, estimating risk parameters, and documenting them internally.
  - The data used for estimation.
  - Quantitative and qualitative validation of the estimated risk parameters.
  - Internal governance.
27. Special attention is devoted to definitions (definition of default, definition of loss), and to the estimation and validation of the risk parameters – Probability of Default (PD), Loss Given Default (LGD) and Conversion Factors (CF) – that are used in the supervisory formula to calculate an institution's risk-weighted exposure amount for credit risk and thus for the calculation of its regulatory capital requirements.
28. In general, this part of the guidelines follows a typical assessment process. The assessment provides comfort to the supervisor that the methodology used in the institution's models, the data used as inputs for the models, and the qualitative risk measurement and control procedures in which the models are embedded, yield risk parameters that adequately reflect the institution's risk profile.

29. The guidelines do not distinguish between a 'Foundation IRB Approach' (F-IRB) and an 'Advanced IRB Approach' (A-IRB). Although these terms are still commonly used by market participants and supervisors, the CRD no longer refers to Foundation and Advanced approaches and there is no distinction between a Foundation and an Advanced approach in the Retail exposure class. An institution can start using the IRB approach (including own estimates of LGD and conversion factors) for the retail exposure class as early as the beginning of 2007. As stated in Article 157(3), for exposure classes other than retail, the use of own estimates of LGD and conversion factors will not be available until 1 January 2008.
30. The third part of the guidelines (section 4 of this paper) covers operational risk. This part focuses mainly on the AMA, but also deals to some extent with the simpler approaches for operational risk. Although some topics already discussed in the IRB section seem at first glance to be repeated here (for example, internal governance and data adequacy), differences in the details of their application to the AMA and IRB approaches make it necessary to discuss them separately. This is not the case for cooperation procedures, approval, and the post-approval process. The procedures described in section 2 of this paper apply equally to the AMA and IRB approaches.

## **2. Cooperation procedures, approval and post-approval process**

### **2.1. Cooperation procedures between supervisory authorities under Article 129**

31. Article 129(2) of the [Directive 2006/48/EC](#) introduces a specific requirement that supervisors must work together to determine whether or not to grant permission to a group to use its internal rating systems (IRB) or operational risk measurement systems (AMA) for regulatory purposes, when the group has submitted a single application covering both the consolidated and solo requirements of the group<sup>57</sup>.
32. In view of this legal requirement, this specific section on the pre-application (see below), approval, and post-approval process (see section 2.2.) has been added to the general guidelines for

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<sup>57</sup> Article 129(2) of the Directive 2006/48/EC governs not only applications to use the IRB and AMA estimates but also applications to use own estimates of Effective Expected Potential Exposure (EEPE) for measuring counterparty exposure on OTC derivative contracts and securities financing transactions. Moreover, according to Article 37(2) of Directive 2006/49/EC, Article 129(2) of the Directive 2006/48 also applies to institutions applying for the use of Value at Risk (VaR) models for market risk. These guidelines discuss Article 129(2) of the Directive 2006/48/EC as it concerns IRB and AMA applications but not EEPE or Market risk model applications.

cooperation between consolidating supervisors and host supervisors. It elaborates upon the general guidance given in the following areas:

- The specific steps in the approval process.
  - The explicit requirement for a formal consultative process.
  - Time limits in which this process should lead to a common decision.
  - The specific role of the consolidating supervisor in this consultation period.
33. The new legal requirements relating to the approval process neither justify nor require any departure from the general guidance for supervisory cooperation on a cross-border basis. The general principles set out in the Guidelines for cooperation between consolidating supervisors and host supervisors therefore remain valid and relevant for supervisory cooperation on the approval process.
34. To facilitate a common decision within the six-month period specified in Article 129(2) of the Directive 2006/48/EC, supervisors have agreed on a common understanding on the pre-application, approval, and post-approval phases (see section 2.2.). An illustration of the steps in the pre-application and approval process and the cooperative interaction in this process is provided in Annexes I and II of these guidelines.
35. A group may enter into exploratory discussions with the consolidating or host supervisors about the use of internal models for all or parts of its business. While there is no formal requirement to do so, supervisors are expected to communicate the outcome of these discussions to other relevant supervisors, and to inform the group of the nature of the approval framework and of the fact that applications will be coordinated through the consolidating supervisor.
36. However, as soon as a group expresses a clear intention to move towards the advanced approaches, even before an application is made, it is essential that the pre-application process be centralised with the consolidating supervisor, acting as the coordinator and the central point of contact for the group.
37. Supervisors have a relatively tight timeframe of six months after receipt of a complete formal application in which to reach a decision on the approval. The pre-application period thus becomes an important step in ensuring that the approval process for both the group and its supervisors is conducted in an efficient, coordinated, and effective manner.
38. During this pre-application period it is essential that:
- Supervisors understand the extent and nature of the intended use of internal rating and operational risk management systems (for

example, which risks, entities, and exposures are to be covered, how internal models are being rolled out across the group, governance and risk management arrangements, data collection and management, and testing).

- All supervisors concerned be consulted to establish a cooperative and consultative framework. This framework needs to encompass the following.
- Which supervisors are to be involved, their respective roles and responsibilities, and the allocation of specific tasks;
- A communication strategy and escalation process; and
- Procedures to ensure that a consensus can be reached among supervisors.
- Supervisors develop an overall supervisory plan of action that covers each of the steps in the approval process and that includes priority issues and a timetable.
- The group familiarises itself with the approval framework and the requirements and standards concerning the information that it will need to submit.<sup>58</sup>
- There is early identification and communication of any specific group or local concerns or issues that need to be factored into the process.
- Supervisors seek to identify potential areas of disagreement.
- Supervisors agree, after due consultation with the group, on the format and timescale for the submission of the formal application and the planning of the assessment to be undertaken by supervisors.<sup>59</sup>
- Supervisors agree on the way that the eventual implementation of the rating and operational risk measurement systems will be structured and monitored.<sup>60</sup>

39. Responsibility for organising and coordinating these pre-application tasks, and more generally for the overall approval process, shall reside with the consolidating supervisor. This responsibility cannot be delegated to another supervisor, although certain tasks – including practical coordinating aspects – may be allocated to other supervisors involved. Thus, for example, while it is expected that the consolidating supervisor will lead the assessment of centrally developed models and the assessment of the group's governance and centralised risk management functions, host supervisors could lead the assessment of locally developed models and local implementation of centrally developed models. The effective coordination of practical work on specific models (e.g. for certain

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<sup>58</sup> See Section 2.2.1. for more details on the information to be submitted.

<sup>59</sup> See Section 2.2. for details on format and timeframe of applications. Additional information on the assessment of applications can be found in Section 2.2.2.

<sup>60</sup> Section 2.2.5. provides details on the post-approval process.

- business lines) can, under the responsibility of the consolidating supervisor, be entrusted to the supervisor best placed to ensure the efficient running of the process. This can also apply to centrally developed aspects of the models (see also Annex I of these guidelines).
40. Consolidating supervisors should liaise with host branch supervisors of systemically relevant branches to determine the extent to which the latter can contribute to the efficiency of the process. For example, by virtue of their proximity, host branch supervisors can offer valuable insights into the impact of local market conditions on models, or can assist in the assessment of data. This is not intended to add additional responsibilities for branch supervisors, but rather to ensure that the process takes maximum advantage of local knowledge.
  41. Special attention should be given to ensuring that information is exchanged upon receipt of a formal application, and to coordinating work on assessing the completeness of the application.
  42. Upon reaching a decision, the consolidating supervisor shall coordinate the drafting of a communication in which the supervisory decision is, duly documented in accordance with Article 129(2) of the [Directive 2006/48/EC](#). The consolidating supervisor should seek an appropriate procedure for formalizing the adherence of all concerned supervisors to the decision.<sup>61</sup>
  43. The CRD specifies that the consolidating supervisor shall make the final determination in the event that supervisors cannot reach a consensus. This is regarded as an exceptional circumstance. Supervisors should try to avoid this outcome by identifying potential areas of disagreement early in the process and prioritising them for early discussion.
  - 43a. Supervisors will also ensure adequate communication with the banking group through an ongoing dialogue (see also Annex I of these guidelines).

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<sup>61</sup> For more details concerning the decision see Section 2.2.3.

## **2.2. Approval and post-approval process**

44. The CRD requires both institutions and supervisors to manage complex procedures when an IRB or AMA approach is to be used for regulatory purposes. Before an application is made, there will usually be preliminary contacts between the institution and its supervisor. In the case of a cross-border group wanting to use its systems not only in the home-country but also in host countries, there will also be preliminary contacts between the consolidating and host supervisors. After the application has been submitted, it has to be assessed by the supervisor(s), a decision has to be taken on it (these three steps – application, assessment, and decision – together constitute the approval process), and – if the application is approved – the roll-out plan and any terms and conditions on which the approval was conditioned have to be monitored (post-approval process). To streamline these complex tasks, CEBS has agreed on the following common understanding with regard to the approval and post-approval process.
- 44a. In most cases, the formal application will follow on from a pre-application phase. In these cases, supervisors will seek to avoid unnecessary duplication of work, for both the institution and themselves. Both the consolidating supervisor and the host supervisors will already have cooperated in the pre-application phase in the spirit of Article 129, thereby facilitating the whole process.

### **2.2.1. Application**

#### **2.2.1.1. Minimum Content**

45. To decide on an application, the supervisor needs an overview of the models that the institution uses or plans to use and how they will be implemented in the institution's policies and procedures, and detailed information on the construction and calibration of the models, the database, the technological environment, and related policies and procedures, including the institution's control environment.
46. An institution or group applies for the general use of internal rating systems to calculate minimum capital requirement for credit risk, or for the use of operational risk measurement systems to calculate the minimum capital requirements for operational risk, or both. The required minimum documentation for such an application is divided into five parts:
- a. Cover letter requesting approval.*
  - b. Documentation of used or planned rating systems and operational risk measurement systems (including models used).*

- c. Control environment of the rating systems and operational risk measurement system, implementation procedures, and IT infrastructure.*
  - d. Implementation plan (including Roll-Out) and details on permanent partial use.*
  - e. Self-assessment.*
47. If any of these documents are not provided by the institution, or if they do not meet the standards set out in the guidelines below or in more detailed standards imposed by the competent supervisor, the application will not be considered complete. Documents (b) through (e) are considered to be supporting material. Unless otherwise indicated, the supporting material should be general information about the implementation of the chosen risk measurement approach.
48. The supporting material provides a summary of the institution's current or planned practices in sufficient depth to enable the supervisor to make an initial supervisory assessment of the application, and to develop a risk-based plan for a more thorough assessment.

### **Cover letter**

49. The cover letter should state that the members of the EU group jointly apply for the permissions referred to in Articles 84(1), 87(9) and/or 105 of the [Directive 2006/48/EC](#), subject to the details provided in the attached documentation. The letter should also confirm that the material attached to the application is a true and fair summary of the topics covered. 'True and fair summary' means that the document provides only a summary of the topic in question, 'true' means that the information contained in the summary is not false or misleading, and 'fair' means that the information presents a reasonable overall summary, without omitting material facts.

### **Documentation of rating systems and operational risk measurement systems**

50. For an application to use the IRB Approach, it is essential that the documentation of rating systems include at least:
- A list of all internal documents held by the applicant that it considers relevant to the application, including a brief description of their contents.
  - A map of the models that the institution will use for each of its portfolios. For IRB, a 'map of models' means a statement that

- explains which exposures, legal entities, and geographical locations are covered (or will be covered) by each rating system.
  - A general description of each of the models. This can include a description of the types of data used, the definitions, classifications and the methodologies used, and some quantitative and qualitative assessments.
51. For an AMA application, it is essential that the documentation of operational risk measurement systems include at least:
- A list of all internal documents held by the applicant that it considers relevant to the application, including a brief description of their contents.
  - A map of the models to be used. For AMA, this means a statement that explains which operations and/or operational risks are covered by each model.
  - A general description of all the models. This can include a description of the types of data, including the four elements (see paragraph 454, below), the definitions, classifications, and methodologies used, and some quantitative and qualitative assessments.
  - The allocation of operational risk capital between different entities within the group, and the use of diversification effects.
  - If the institution uses capital-relief tools, documentation should be provided on the coverage and measurement of expected loss, the institution's operational risk insurance policy or other risk transfer mechanisms, and the use of correlations.
- 52.
- 52a. The list of documents referred to above is intended to be a comprehensive list of all the institution's internal documentation underlying its validation process (including documentation on external vendor models, if used) that the institution judges to be relevant to its application.
53. Supervisors may request more detailed information, either in the initial application or at a later stage, to allow an effective assessment of the application. These documents, like all internal documentation, have to be made available to supervisors upon request.
54. For example, additional documentation requested for IRB applications may include, but is not limited to, the information listed in Annex VII, Part 4, Paragraphs 31 to 35 (documentation of rating systems) and Annex VII, Part 4, Paragraphs 110 to 114 (validation of internal estimates) of the [Directive 2006/48/EC](#), covering the following areas:
- Design and operational details.
  - Major changes in the risk rating process.

- Definitions of default and loss.
- Use of models obtained from third-party vendors.
- Differences, if any, between the parameters used for the calculation of regulatory capital requirements and those used for internal purposes.
- Validation of rating systems.
- Model assessment processes.

55.

56.

### **Control Environment**

57. The documentation of the control environment, implementation procedures, and the IT infrastructure should include, as a minimum:
- An overview of the internal governance of the institution (i.e., the role and responsibilities of management, the functions of committees involved in governance, and the role of Internal Audit).
  - The planned use of the different rating systems and operational risk measurement systems (how, in practical terms, institutions plan to use different models in the operating activity).
  - For IRB, the process of rating assignment.
  - The responsibilities of the parties involved in modelling.
  - An overview of the validation process.
  - General information on the institution's IT structure, as far as IRB and AMA approaches are concerned.
  - Internal Audit reports (if applicable).

As with other types of documents, more detailed information about the implementation of the rating systems and operational risk measurement systems can be provided later upon request.

### **Implementation plan**

58. Institutions intending to move to an AMA or IRB approach are expected to prepare a meaningful implementation plan (including roll-out), and to submit it to the supervisor as part of the application pack. The implementation plan is a commitment on the part of the institution to implement the AMA or IRB approaches on the specified dates for all of the rating systems and operations for which it is seeking approval to use the AMA or IRB approaches. It is an essential part of the application. The terms 'implementation plan' and 'roll-out plan' are sometimes used synonymously by the industry and

supervisors. However, Article 85 refers only to 'implementation,' and there is a common understanding among supervisors that there is a difference in terms of the time period covered. 'Roll-out plan' refers to the time after the initial approval has been granted, whereas 'implementation plan' also covers the time prior to approval. The roll-out period is thus shorter than, but entirely a subset of the implementation period.

59. The implementation plan (including roll-out) for IRB should be broken down at least by supervisory exposure classes, business units, and, if applicable, any IRB parameters that need to be estimated. Internal rules with detailed provisions regarding time and content should be laid down for combinations of the above, in particular for the following:
- Development of the rating methodology.
  - Preparation of the technical concept for IT implementation of the rating methodology.
  - IT implementation.
  - Training of staff, including management staff.
  - Transition from the existing rating system to the new system on the basis of current business, if a transition is made.
  - Formal internal acceptance of the new rating system and implementation as 'the' rating system of the institution.
60. In addition, a list of all portfolios which are to be permanently exempted from the IRB Approach is to be provided. The exempted portfolios should be quantified comprehensively (e.g., number of material counterparties, credit aggregates in the exposure value, and Risk-Weighted Exposure Amounts).
61. As far as the implementation plan (including roll-out) for AMA is concerned, internal rules with detailed provisions regarding time and content are to be laid out for the following:
- Development of operational risk management processes, in particular for data collection.
  - Development of the measurement methodology.
  - Implementation of the IT infrastructure which is used for operational risk management and measurement purposes.
  - Training of staff, including management staff.
  - The 'use test.'

### **Self assessment**

62. The institution should carry out a self-assessment of its state of readiness based on the standards and minimum requirements set out in the CRD. It should develop an action plan to fill identified gaps and deficiencies, and a schedule for achieving compliance.

63. The self-assessment should begin with a global assessment, from a consolidated perspective, of how the various models fit together within the institution or the group. This global assessment should cover the suitability of the organizational structure in terms of internal governance, the adequacy of resources devoted to the rating system or operational risk measurement system, comparability across the group with respect to data and methodology, and consistency in IT organization.
64. The self-assessment should also cover all the aspects of the rating system or operational risk measurement system: methodology, quality of data, quantitative and qualitative validation procedures, internal governance, and technological environment. The self-assessment could be conducted by staff from an independent risk assessment function with the support, if necessary, of auditors or inspectors teams or a combination of all the resources including also the participation of external auditors and consultants.

#### **2.2.1.2. Language and signatory**

65. The application should be signed by an executive member of the management body referred to in Article 11 of the [Directive 2006/48/EC](#)<sup>62</sup> who has the authority to commit the institution. It is not possible in these guidelines to identify that person more precisely, since his or her identity will depend on national legal systems and some supervisors may require more than one signatory. Therefore, the consolidating supervisor should identify the exact person or persons who should sign the application, at least one of whom should be an executive from the management body.
66. The signatory signs the application on behalf of all the legal entities making the joint application. The signatory also confirms that the material attached to the application is a true and fair summary of the subjects covered. Depending on the national legal system, supervisors may ask a member of the management body of each legal entity affected to sign the joint application.
67. The cover letter should be in an official language of the consolidating supervisor or another language acceptable to the consolidating supervisor. The other documentation in the application should be in a language or languages agreed between the institution, the consolidating supervisor, and the host supervisors. Communication between supervisors should be in a language of mutual understanding, chosen on a bilateral basis. If documents need to be

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<sup>62</sup> Hereafter, any reference to the management body will have the meaning of management body as referred to in Article 11 of the Directive 2006/48/EC ([http://eur-lex.europa.eu/LexUriServ/site/en/oj/2006/l\\_177/l\\_17720060630en00010200.pdf](http://eur-lex.europa.eu/LexUriServ/site/en/oj/2006/l_177/l_17720060630en00010200.pdf)).

translated, supervisors will organise this in cooperation with the institutions.

### **2.2.1.3. The starting of the six-month period**

68. The six-month period for making a determination on an application shall begin on the date that a complete application is received by the competent authority referred to in Article 129(1). Specifically, the clock starts as soon as the supervisor has received an application that is complete with respect to the signatory, format, content, and minimum requirements set out by its consolidating supervisor, which will take into account the requirements set out in Section 2.2 of this paper.
69. The supervisors involved perform a preliminary assessment of the entire application immediately upon receipt. If the application is complete in all essential aspects and does not raise any significant doubt or non-satisfaction in this regard or with respect to the requirements mentioned above, the clock starts upon receipt. If the application lacks essential parts or is otherwise deemed incomplete, the supervisor will communicate this to the institution. Depending on the seriousness of the deficiencies, the applicant is either allowed to supplement the application or is asked to provide a new application at a later date. When the application is complete, the clock starts.
70. There is no provision under Article 129(2) to stop the clock once a complete application has been received. However, a pause in the six-month period may be acceptable if the applicant no longer meets the requirements for a complete application. If during its examination the supervisor discovers essential deficiencies concerning the completeness of the application, it may offer to suspend further examination of the application until the deficiencies of the application are corrected, as an alternative to rejecting the application.
71. The operation of the clock is the responsibility of the consolidating supervisor. This includes promptly making any change in the status of the clock known to all involved parties, including the applicant. The timetables for the approval process should be planned and coordinated by the consolidating supervisor and agreed on by all the supervisors involved. Consolidating and host supervisors should aim at agreeing on plans which accommodate the needs for flexibility for all supervisors involved. This holds special importance where an entity in a host country is significant for the applicant or is considered of systemic importance by the host supervisor.

### **2.2.2. Supervisor's Assessment**

72. The supervisor has to assess whether or not he is satisfied that the institution's systems meet the standards listed in Article 84 in

- accordance with the requirements of Annex VII, Part 4 of the [Directive 2006/48/EC](#) and/or the qualifying criteria set out in Annex, Part 3 of the Directive 2006/48/EC. This assessment does not necessarily have to begin only when an official application has been submitted, but could start in the pre-application phase.
73. Before entering into the assessment of the details of the rating or operational risk measurement systems, it is necessary for the supervisor(s) to form an opinion of the overall picture. The issues that should be analysed include, among others:
- The suitability of the organizational structure, in terms of the responsibilities and functions assigned to the different areas involved in managing, measuring, and controlling risks.
  - The sufficiency of the human and material resources assigned.
  - The practicality and feasibility of the implementation plan for institutions adopting a phased roll-out.
  - The group structure, including the legal entities within the group (data, methodology, controls, etc.) and regulatory capital requirements.
74. In order for the IRB approach to be recognised for regulatory purposes, it must be validated by the institution. The term 'validation' encompasses a range of processes and activities. For the IRB, this includes whether ratings adequately differentiate risk and whether estimates of risk components (such as PD, LGD, or CF) appropriately characterise the relevant aspects of risk. For the AMA, it includes the quality and soundness of the operational risk management processes and measurement systems. Validation has to be performed by the institution, and needs to take into account the specific purpose or purposes for which a rating system or an operational risk measurement system is being used. Supervisors use their own methods to assess the validation process, or certain parts of it. These methods may include off-site analysis or on-site missions, conducted by their own or external staff. When using the latter, supervisors should take care that no confidentiality issues /conflicts of interest will arise. Supervisors will pay special attention to the validation for regulatory capital purposes.
75. The institution's validation consists of examining and reviewing all the elements in the rating or operational risk measurement systems and controls, for every portfolio to which the IRB approach is applied and all operations relevant to the AMA, in order to verify that they:
- Satisfy the use test.
  - Produce outputs suitable for all intended purposes, including regulatory capital requirements.

- Are suitable for the specific circumstances in which the models are used (e.g., countries, size, and complexity of portfolios in the case of IRB, and business lines in the case of AMA).
  - Meet all other minimum regulatory requirements, insofar as applicable.
76. The issues that supervisors are expected to assess can be broken down into five phases:<sup>63</sup>
1. Methodology and documentation.
  2. Data quality.
  3. Quantitative procedures.
  4. Qualitative procedures.
  5. Technological environment.
77. In assessing IRB applications, the issues are:
1. Methodology and documentation: Supervisors will examine and assess the rating system methodology and the quality of internal documentation supporting the rating system.
  2. Data quality: Supervisors will assess the quality of data and databases being used for the development of the rating systems, in the rating assignment process, and in the estimation of risk parameters, along with any other databases needed to calculate minimum regulatory capital. This is to ensure the soundness of calibration and of the capital calculation. (The latter holds true also for the other four items mentioned here.)
  3. Quantitative procedures: Supervisors will assess the quantitative information provided by the applicant relating to performance, validation, and monitoring of rating systems. Supervisors may ask applicants to undertake additional analyses and may undertake quantitative procedures of their own.
  4. Qualitative procedures: This phase has two objectives. The first is to perform an overall assessment of the quality of the internal model. This involves integrating all the information generated in the previous phases and discussing with the applicant the appropriate interpretation of the data with respect of the quality of the rating system. The second objective is to assess compliance with the qualitative minimum regulatory requirements. Supervisors will assess the use test, internal governance, the role of senior management, the adequacy of

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<sup>63</sup> The phases are numbered, suggesting a certain logical order, although in practice some phases will probably overlap.

internal controls, and other areas in order to assess the qualitative aspects of the rating system that have a bearing on the approval and to check for compliance with the minimum qualitative requirements.

5. Technological environment: Supervisors will evaluate the reliability and integration of systems, the functionality of the model, and the quality of information provided by systems.
78. In assessing AMA applications, the issues are:
1. Methodology and documentation: Supervisors will examine and assess the risk measurement methodology and the quality of internal documentation supporting the methodology.
  2. Data quality: Supervisors will assess the quality of data and databases being used in the risk measurement system, including the four AMA elements (see paragraph 454 below). This is to ensure the soundness of the data set used for estimation and also the correctness of the capital calculation.
  3. Quantitative procedures: Supervisors will assess the reasonableness and robustness of the assumptions and techniques used to model internal data, integrate internal and external data, generate scenario data, and incorporate business environment and internal control factors into the operational risk measurement system. Supervisors will also assess some of the issues linked to parameter estimation and validation. Supervisors will discuss with applicants the appropriate interpretation of the data with respect of the quality of the risk measurement system. Supervisors may ask applicants to undertake additional analyses and may undertake quantitative procedures of their own.
  4. Qualitative procedures: Supervisors will assess the use test, internal governance, the role of senior management, the adequacy of internal controls, and other areas in order to assess the operational risk management processes and the qualitative aspects of the risk measurement system that have a bearing on the approval.
  5. Technological environment: supervisors will evaluate the reliability and integration of systems, the functionality of the model, and the quality of information provided by systems.
79. To make the supervisor's assessment more efficient, the supervisor(s) may also rely on work undertaken by the institution's own resources (Internal Audit, the unit responsible for internal validation of models, model users) or external resources (e.g.

external auditors) to facilitate some tasks, or even some phases. Without a previous validation carried out by the institution, supervisors cannot perform an assessment that approves the use of the AMA or IRB approaches with a reasonably acceptable supervisory risk. For this reason, validation by the institution becomes a prerequisite for assessment by supervisors.

### 2.2.3. Decision and permission

80. After the supervisors have made their assessment, a decision has to be made whether or not to approve the use of the IRB or AMA approach for regulatory purposes. Article 129(2) of the [Directive 2006/48/EC](#) provides that when an application for the permissions referred to in Articles 84(1), 87(9) and 105 is submitted by an EU parent institution and its subsidiaries, or jointly by the subsidiaries of an EU parent financial holding company, the competent authorities shall work together, in full consultation, to decide whether or not to grant the permission sought and to determine the terms and conditions, if any, to which the permission should be subject. Furthermore, within six months, the competent authorities shall do everything within their power to reach a joint decision on the application. This joint decision shall be set out in a document containing the fully reasoned decision.
81. It is important to distinguish between 'decision' and 'permission.' The decision is the final act in the approval process, as a result of the consultation between the competent authorities. The permission is the legal form by which this decision, determinative and legally binding on the competent authorities, comes into force in their respective legislation. The permission is the transposition of the full content of the decision under the standing legal provisions of each country.
82. A joint decision could contain group-specific or nation-specific terms and conditions. Another type of joint decision could be the dismissal of the application. It is also possible for permission to be granted without any terms and conditions. The final responsibility for the decision-making process rests with the consolidating supervisor. The procedural law of the consolidating supervisor's legislation determines the proceeding and the legal form of the decision which shall be provided to the applicant.
83. The CRD requires the document to contain the fully reasoned decision. If the decision is made subject to certain terms and conditions, these need to be clearly articulated in the document. It may also cover recommendations for the possible improvement of any deficiencies revealed during the assessment process.

84. The justification of the decision should contain references to both the legal framework, which generally stipulates the supervisor's assessment, and the application document, which effectively triggers the approval process in specific cases. Although not explicitly required by the CRD, certain issues will naturally form part of the decision document. These might include (but are not limited to) the following:
- a. Commentary on the application, with particular regard to the scope of the application and the scope of the models themselves.
  - b. Assessment of the application, in particular, with reference to the assessment against the CRD's requirements.
  - c. Milestones and recommended or mandatory remedial action, possibly expressed as terms and conditions to the decision, as well as suggestions for the possible improvement of any deficiencies.
85. The transposition of the decision will take place in accordance with the national provisions in each country and should take place shortly after the decision has been taken. In reaching a decision, the consolidating supervisor has the responsibility for coordinating a timeframe for implementing the decision, based on information on national transpositions provided by the supervisors.
86. In accordance with Article 129(2), supervisors are required to implement the decision, and they carry full responsibility for doing so within the agreed time frame. The agreed time frame should be included in the decision document. The same holds true for the agreed arrangements for dealing with portfolios as they are rolled out, including the requirements with respect to the use test (see sections 3.1.1., 3.2. and 4.3.1. and especially paragraphs 107 and 431 of this paper).
87. The single document decision shall be transposed in a fully binding manner by national permissions. The decision is legally binding for the competent authorities involved. The Article 129(2) process ends when the decision and permission are provided to the applicant.

#### **2.2.4. Change in the consolidating supervisor**

88. Cross-border mergers and acquisitions and other structural changes may have an impact on planning the approval process, or even on an approval process that is already underway. In the latter case, such changes could imply a change in the responsible consolidating supervisor. In such cases:
- It is essential that the consolidating supervisor has all relevant information on possible structural changes of the group at the

beginning of the approval process. Information on mergers and acquisitions and other structural changes is typically exchanged during the ongoing home-host supervisory process, but it is useful to update this information at the beginning of the approval process.

- In a changing environment, effective consultation with all relevant supervisors at a very early stage is important before detailed step-by-step planning of the approval process.
- In assessing the application, supervisors shall identify anticipated changes in the consolidating supervisor and/or host supervisors which will impact on the approval process.
- If it is foreseeable that a change of the consolidating supervisor will take place during the approval process, the relevant supervisors shall take these changes into account when planning the assessment process (i.e., communication, allocation of tasks, etc.).
- A new approval process shall not be started after a change in consolidating supervisor. However, cross-border mergers and acquisitions of institutions, in particular, may justify modifying the approval process (see also sections 3.1.1. and 4.3.1.).
- A fully reasoned decision to implement IRB or AMA approaches shall remain valid even after a change in consolidating supervisor.
- The legal responsibilities and duties of competent authorities laid down in Article 129 shall not be altered in the event of structural changes in cross-border groups. Furthermore, the guidelines for cooperation between home and host supervisors shall be implemented, even in such a changing environment.

### **2.2.5. Post-approval process**

89. Once the approval process has ended, supervisors have to monitor the roll-out plan and any terms and conditions to which the approval was subject. If, after the approval, a new decision (but not necessarily a new approval process) should become necessary due to the fulfilment of or changes in the roll-out plan, national authorities will cooperate in the spirit of Article 129(2). The same holds true for the monitoring of terms and conditions associated with the approval.
90. After the roll-out period, the fulfilment of terms and conditions attached to the permission shall be monitored in consultation between consolidating and host supervisors in line with the Guidelines for Cooperation between Home and Host Supervisors.
91. A proposal to revoke an Article 129(2) decision can be made by the consolidating supervisor, a host supervisor, or the institution itself. The Article 129(2) decision can be revoked by joint agreement of the consolidating supervisor and the host supervisors, or, in the absence

of an agreement, by the consolidating supervisor alone. A host supervisor cannot revoke an Article 129(2) decision acting on its own.

#### **2.2.6. Transition period**

92. At the date of initial publication of this paper, the CRD had not yet come into force. Therefore, formal applications (in the sense that they refer to a legal basis that has already been implemented in national legislation) was not yet possible. However, in order to smooth the application process and to allow substantive early consideration of applications in order to make it easier for institutions to meet the requirements to use the IRB approach from 1 January 2007 (in the interest of both the industry and the supervisory authority), some countries had introduced arrangements under which preliminary (also called early or informal) applications can be made, prior to the CRD being transposed into national legislation. Such preliminary applications could not be considered formal applications at any time prior to the transposition of the CRD; nor can decisions reached on them be considered formal decisions.
93. Other countries did not accept preliminary applications, due to national legal restrictions. However, as mentioned in section 2.1. of this paper, there will be an intense pre-application period in all countries to ensure an efficient process once the CRD is transposed into national legislation.
94. The same standards for supervisory cooperation and the same minimum requirements for applications, assessments, and decisions will be applied during the transition period as for later formal applications. For example, early applications should meet the minimum content, signatory, and language guidance described above.
95. Supervisors accepting preliminary applications before the provisions of the CRD enter into force will voluntarily operate according to most of the elements of Article 129(2) for processing these applications. Specifically:
  - They will accept joint applications as described in Article 129(2).
  - They will do everything within their power to reach agreement on the decision.
  - A fully reasoned decision will be provided to the applicant.
96. Other guidelines relating to the approval process will be observed. For example, early applications should meet the minimum content, signatory, and language guidance described above.

97. As the CRD has come into force, institutions that have made preliminary applications may be asked to submit a formal application under Article 129(2). In that case, supervisors will accept the cover letter by itself as an application, with cross references to the supporting material submitted previously in connection with the informal application. Where a decision has already been reached on an early application, and there is no new information that would lead supervisors to reconsider their decision, the decision reached previously will be treated as determinative and binding on supervisors.

### **3. Supervisor's assessment of the application concerning the minimum requirements of the CRD – Credit Risk**

#### **3.1. Permanent Partial use and roll-out**

98. Although, according to the CRD, once an institution decides to apply the IRB approach, all exposures should be covered by this approach, in practice two facts are taken into account:
- Institutions may not be ready to apply the IRB approach at the time the CRD is legally adopted.
  - The extension of rating systems to some parts of their business may be unduly burdensome and may not create value.

##### **3.1.1. Roll-out**

99. Article 85 of the [Directive 2006/48/EC](#) gives institutions the possibility of implementing the IRB Approach sequentially across different exposure classes, while Article 89 permits them to exempt certain exposure classes permanently. However, supervisors would expect institutions already to be using the IRB approach for at least a portion of their business when they apply for approval to use the IRB approach for regulatory purposes.
100. As a general principle, the rating systems used should cover all exposure classes (Article 85(1) of the [Directive 2006/48/EC](#)). However, it is likely that only some exposure classes will be covered when the formal application is submitted or after the initial approval to use the IRB has been granted. Supervisors will examine the institution's implementation plan to ensure that it is credible and feasible with regard to initial coverage and the pace of roll-out.

101. Supervisors may decide to adopt quantitative or qualitative rules. Under a quantitative rule, a certain percentage of an institution's risk-weighted exposure amounts and/or exposure value would have to be covered in order to start the approval process. Under a qualitative rule, exposure classes or portfolios that represent the core business of the institution should be covered. Although supervisors will apply different approaches (qualitative or quantitative) and use different thresholds, it can be stated as a common rule that the lower the threshold, the shorter the time frame for the roll-out in order to achieve a sufficient degree of representativeness.
102. The institution's roll-out policy should indicate at least the time horizon and the roll-out sequence. The roll-out plan should have a definite time horizon. Article 85(2) of the Directive 2006/48/EC requires that IRB implementation "shall be carried out within a reasonable period of time." This period should reflect the institution's realistic ability to convert to the IRB Approach and the supervisors' expectations that the institution's core business and main credit risk drivers will be covered by the IRB Approach as quickly as possible.
103. The time horizon should be short enough to avoid prolonging IRB applications unduly, and long enough to ensure the quality of data, methodology, and output. Since supervisors must retain discretion to take account of certain special features of the institutions in their member state, the setting of a common, EU-wide maximum time frame does not appear useful.
104. The sequence of exposure classes in the roll-out of the IRB approach can be chosen by the institution or set according to a rule specified by supervisors. In general, the sequence should be the institution's choice, relying on the institution's best efforts. If the sequence is determined by supervisors, the more important portfolios (i.e., portfolios that represent the institution's core businesses) should be rolled out first. In any case, institutions are expected to take the importance of the exposure classes into account, and this will be part of the supervisors' decision-making.
105. Since the application, if accepted, contains a complete roll-out plan, no further Article 129 application will be needed as each portfolio is rolled out, with the possible exception of a merger or acquisition (see below). (See also section 2.2.5. on the post-approval process.)
106. Recognising that it is the responsibility of institutions to meet the minimum requirements, institutions should carry out a self-assessment against the requirements of the CRD before rolling out exposure classes. National supervisors will monitor an institution's progress in implementing its approved roll-out plan. Supervisors may wish to take additional steps to satisfy themselves that the minimum requirements are met before each step of the roll-out can be

implemented and used for the calculation of the capital requirements.

107. As stated in paragraph 105, where an institution makes use of the roll-out, there will be no need for a fresh Article 129 process as portfolios are rolled out. During the roll-out period, supervisors will continue to cooperate in the spirit of Article 129, as stated in paragraph 89. Some supervisors may also introduce supplementary binding milestones during the roll-out period (for example, a certain IRB coverage ratio must have been achieved after the first half of the roll-out period). In order to satisfy themselves that minimum standards continue to be met as portfolios are rolled out, supervisors envisage three available options, and will specify which option or which mixture of options is being used in the decision document; conditions may need to be attached to the decision in order to give effect to the option or options selected. The three options are:
1. Relying on normal supervisory activity to verify that minimum standards are met. Although formal ex-ante notification requirements other than the roll-out plan will not be introduced, institutions will be expected to keep supervisors informed of plans and developments in their risk measurement and management practices. Although an ex-ante assessment by supervisors will not be a formal requirement, supervisors may nevertheless choose to undertake an assessment of the rating system in the period before the institution starts to use it for regulatory capital purposes.
  2. Asking institutions to notify supervisors on a timely basis when they are ready to use a rating system for the calculation of the regulatory capital requirements for an additional exposure class or business unit as stated in the roll-out plan. As with (a), although an ex-ante assessment by supervisors will not be a formal requirement, supervisors may nevertheless choose to undertake an assessment of the rating system in the period before the institution starts to use it for regulatory capital purposes. Or,
  3. Asking institutions to notify supervisors on a timely basis of their intention to roll out to an exposure class. Supervisors may additionally require institutions to receive explicit permission before starting to use the rating system for this exposure class. In this case an ex-ante assessment by supervisors may be required prior to permission being granted.
108. Changes in the roll-out plan could be allowed when significant business environment changes take place, but should be well justified by the institution. Two examples that could justify altering an institution's partial use or roll-out policy are changes in strategy and mergers and acquisitions.

109. A change in strategy could result from changes in shareholders or management, or from a new business orientation. In either case, the time horizon for roll-out should remain the same unless there is good reason for delay, but the roll-out sequence can change.
110. A merger or an acquisition is considered an important event that is likely to call for modifying the institution's partial use and roll-out policies. Two merger or acquisition situations can be distinguished: first, where an IRB institution acquires a non-IRB institution, and second, where a non-IRB institution acquires an IRB institution. In the first case, the IRB institution may be asked to submit a new Article 129 application with a new partial use and roll-out policy, or it may be asked to submit a plan for bringing the entire institution into compliance with the CRD. The second case is more difficult, since the acquiring institution does not have IRB permission, and some requirements, such as senior management understanding, may not be met. The acquiring institution would normally be asked to make a new Article 129 application.
111. The rules and criteria for roll-out plans apply to any step towards the IRB Approach. In practice, this means that an institution planning to roll out the IRB approach in two steps for any of the exposure classes mentioned in Article 87(9) of the [Directive 2006/48/EC](#) (central governments and central banks, institutions, and corporates) – i.e., moving first from the Standardised Approach to supervisory estimates of LGDs and CFs, and subsequently from supervisory estimates of these parameters to own estimates – can use the whole roll-out package for each step. Such an institution would, for example, have a double time-frame for moving to the IRB approach that includes the use of own estimates of LGDs and Conversion factors. However, it is expected that the quantitative aspects in such a two-step roll-out would be reduced due to potential increased skills or gains of scale within institutions.

### **3.1.2. Permanent partial use**

112. Article 89(1)(a) and (b) of the Directive 2006/48/EC provides that institutions that are permitted to use the IRB Approach may be permanently exempted from applying it to the 'institutions' and/or 'central governments and central banks' exposure classes – i.e., they apply the Standardised Approach to these exposure classes instead – if the number of material counterparties in these exposure classes is limited and it would be unduly burdensome for the institution to implement a rating system for these counterparties. Exemptions are subject to the approval of the competent authorities; the riskier the institution's exposure classes, the more supervisors should encourage and expect it to adopt the IRB approach.

113. It is the institution's responsibility to justify permanent exemptions. The justification should explain why the institution feels it unduly burdensome to implement a rating system, how the exposures fit its business and strategy, and whether the exposures fit the scope of its core activities.
114. The absence of default data is clearly a key determinant of whether the IRB approach can be adopted, but does not by itself prove that it would be unduly burdensome to implement a rating system (see section 3.5.3. on low-default portfolios and 3.4.4. on external data) Undue burden could be (but does not necessarily have to be) evidenced by comparison with the business and strategy of the institution.
115. Article 89(1)(c) of the [Directive 2006/48/EC](#) provides that exposures in non-significant business units and exposure classes that are immaterial in terms of size and perceived risk profile can also be permanently exempted from the IRB approach. The term 'business unit' may refer to separate organizational or legal entities, business lines, or delimitable homogeneous groups of exposures within a group (these may often be identified separately in the institution's internal management information systems), or to other types of entities. Geographical location can also be a criterion: a foreign subsidiary or branch or a business conducted in a specific region can sometimes (but not always) be considered a separate business unit. In borderline cases, the goal of this rule should be kept in mind: to allow units to stay in the Standardised Approach if:
- They are technically, geographically, or organisationally separate from other parts of the institution (or group), and implementation for them would be disproportionately costly, or
  - They are small and have customers for which the rating systems of the group are not meaningful, own rating systems cannot be developed, or for which the implementation of own rating systems is too expensive.
- 115a. An example of a delimitable group of exposures is the following. A business unit may be well-defined by a certain type of facilities. Those facilities form a certain type of exposures. Consequently, if a sub-portfolio is well-defined as a business unit formed by a certain type of facilities that form a certain type of exposures and that are homogeneously managed, partial use for this sub-portfolio is possible insofar as an institution can demonstrate that this sub-portfolio is not significant.
116. 'Immaterial' should refer to both the size and the perceived risk profile of the exposure classes. Exposure value could be used as the

- indicator of size, and risk-weighted exposure amounts for credit risk (calculated according to Basel II<sup>64</sup>) as the indicator of risk profile. Alternatively, supervisors may accept a single measure of both the size and the perceived risk profile.
117. The basis of the calculation is total on- and off-balance sheet assets. The threshold should be applied at the level of the institution or group that applies for IRB. No further restrictions should apply to individual institutions or sub-groups within a group.
118. Materiality can be measured:
- at the aggregate level,
  - at the level of the individual portfolio or business unit, or
  - at both levels.
119. The aggregate measurement is mandatory, to ensure that the sum of all exposures in immaterial exposure classes and non-significant business units does not lead to unacceptably high levels of risk and size in the part remaining in the Standardised Approach. An additional measurement at the individual level can be regarded as appropriate by national supervisors if the aggregate threshold would allow a single business unit to account for the entire amount of exposures remaining in the Standardised Approach due to immateriality.
120. Some supervisors may find it useful to set minimum levels of coverage of IRB portfolios. For others, the qualitative assessment is crucial, meaning that the reasons for permanent exemption should be fully set out and credible. National supervisors should take into account the interdependence between minimum thresholds and the granularity of the definition of business unit.
121. Competent authorities will pay particular attention to preventing institutions from exploiting this rule in order to exempt high-risk exposures from the IRB approach.
122. The institution or group which is applying the IRB approach is responsible for monitoring compliance with the materiality criterion. Institutions should have systems and procedures in place that monitor materiality issues in a timely and appropriate manner. If materiality thresholds (if any) are exceeded, the institution should notify the supervisor and present an appropriate remedial action plan over a reasonably short timeframe to be agreed with supervisors. Particular concern should be given to cases where materiality thresholds are breached deliberately (for example, following a

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<sup>64</sup> For those exposures that should remain in the Standardised Approach, the capital requirement is calculated according to the Standardised Approach.

strategic decision to expand in a particular sector). In such cases, a roll-out policy prior to actual expansion should be in place.

123. Exposures for which the institution plans to use permanent partial use according to Article 89(1) of the [Directive 2006/48/EC](#) for reasons other than immateriality (Article 89(1)(c)) are exempt from the calculation of the materiality threshold (i.e., they are excluded from both the numerator and the denominator of the threshold). This applies mainly to the following exposure classes.
- Institutions (limited number of material counterparties).
  - Central governments and central banks (limited number of material counterparties).
  - Equity exposures exempted from the requirement to use IRB.
124. Institutions intending to use the Slotting Approach for the Specialised Lending sub-exposure class are allowed to add these exposures to the part of their portfolio which is treated according to the most demanding IRB approach for the purpose of calculating their IRB coverage ratio.

### **3.2. Use test**

125. A fundamental requirement for an institution to qualify for the IRB approach is that it demonstrates to its supervisors that the information used in or produced by its rating system to determine regulatory capital requirements is also used in the course of conducting its regular business, particularly in risk management.
126. Specifically, Article 84(2)(b) of the [Directive 2006/48/EC](#) states that the internal ratings and default and loss estimates used in calculating capital requirements, and the associated systems and processes, should play an essential role in the institution's risk management and decision-making process, and in its credit approval, internal capital allocation, and corporate governance functions.
127. Article 84(3) of the [Directive 2006/48/EC](#) states that an institution applying for the use of the IRB Approach shall demonstrate that it has been using rating systems, for the IRB exposure classes in question, that are broadly in line with the minimum requirements for internal risk measurement and management purposes, for at least three years prior to its qualification to use the IRB Approach. Similarly, Article 84(4) states that an institution applying for the use of own estimates of LGDs and/or conversion factors shall demonstrate that it has been estimating and employing own estimates of LGDs and/or conversion factors in a manner that is broadly consistent with the minimum requirements for use of own estimates for at least three years prior to qualifying to use own estimates of LGDs and/or conversion factors for regulatory purposes (see also paragraph 147).

128. For institutions applying for the use of the IRB Approach before 2010, the three-year use requirement prescribed in Article 84(3) may, until 31 December 2009, be reduced to a period not shorter than one year, subject to the approval of competent authorities. Similarly, for institutions applying for the use of own estimates of LGDs and/or conversion factors, the three-year use requirement prescribed in Article 84(4) may, until 31 December 2008, be reduced to two years.
129. Article 84(2)(b) of the [Directive 2006/48/EC](#) implies that rating systems, ratings, and default and loss estimates designed and set up with the exclusive aim of qualifying for the IRB, and used only to produce the data necessary for the IRB approach, are not allowed. While ratings and default and loss estimates must play an essential role in the relevant processes of the institution, this does not mean that they must in every case be the exclusive information or the final parameters used for internal purposes such as pricing. Nevertheless, institutions should be required to demonstrate that those ratings and estimates play an essential role in the processes and functions listed in Article 84(2)(b), and they should indicate where different final parameters are used internally. If institutions use different estimates for the calculation of risk weights and internal purposes, this shall be documented and their reasonableness shall be demonstrated to the competent authority (Annex VII, Part 4, Paragraph 55 of the Directive 2006/48/EC).
130. Supervisors should distinguish between two aspects of the use test when assessing an institution's compliance with Article 84(2)(b) of the Directive 2006/48/EC:
- scope
  - use of data for internal purposes

### **Scope**

131. An institution's rating systems and processes and its internal ratings and default and loss estimates should be an integral part of its business and risk management culture.
132. Institutions should make effective use of internal ratings and the resulting risk parameters. Ratings and risk parameter estimates used in calculating capital requirements must play an essential role in the risk-management and decision-making process, and in the credit approval, internal capital allocation, and corporate governance functions of the institution. If not all these processes and functions are based solely on ratings and risk parameter estimates used in calculating capital requirements, at least an effective and material part of them should be, so that the ratings and risk parameter estimates used in calculating capital requirements have a substantial influence on the institution's decision-making and actions.

- Institutions will ensure that the use of these data is not marginal, and will assess the validity of differences, e.g., between a pricing PD and the rating PD. Supervisors can stress that risk management elements such as ratings or internal reporting need to be strongly linked with ratings and risk parameter estimates used in the calculation of capital requirements, while for some other functions (such as pricing) they could be less strongly linked.
133. 'Playing an essential role' does not mean that the data/parameters used in calculating capital requirements need to be identical to, or a linear and homothetic function of the data used for credit management. It means that there is a strong relationship between the data/parameters used in calculating capital requirements and the data used for credit management. If institutions use different estimates for the calculation of risk weights and internal purposes, this shall be documented and their reasonableness shall be demonstrated to the competent authority (Annex VII, Part 4, Paragraph 55 of the Directive 2006/48/EC).
  134. Institutions should identify and describe the use they make of internal ratings, relevant risk parameters, and all related systems and processes. They should provide such documentation to their supervisor so that the impact on the institution's operations can be assessed. Such documentation should be updated regularly by (for example) the credit risk control function, and reviewed by internal audit or another comparable independent audit unit.
  135. Prior to granting permission for the use of the IRB approach, supervisors should check the total capital requirements calculated based on all the approaches/methods/rating systems that the institution intends to use at the time of the initial permission to use the IRB approach. An analogous check should be performed prior to granting permission to use additional approaches, methods, or rating systems, subsequent to the initial permission to use the IRB approach. The purpose of these checks is to ensure that the institution's systems for managing and rating credit risk exposures are sound and implemented with integrity. Institutions will be required to report their total capital requirements to supervisors in order to obtain the respective permission. Some supervisors might retain a limited reporting but would be keen on checking its accuracy, others would prefer a more extended running of reporting lines.

### **Use of data for internal purposes**

136. It is not always necessary that data used in calculating capital requirements serve directly as the only information or the final parameters for all internal purposes. However, any differences should be assessed carefully by supervisors. The use for internal

- purposes of the data used in calculating capital requirements should be as comprehensive as necessary to ensure that those data play an essential role in the processes and functions listed in Article 84(2)(b) of the Directive 2006/48/EC.
137. Data categories should be distinguished. Inputs in the form of data published in financial statements, for example, have to be distinguished from estimated data which result from the institution's calculations. All of the institution's estimates of risk parameters should start with inputs, and those inputs should be essentially the same whether used for credit management purposes or for regulatory calculation purposes.
  138. The rating systems used for rating obligors and exposures and for estimating risk parameters used in the calculation of capital requirements must also play an essential role in the relevant processes and functions of the institution. Moreover, the structure and design of the rating systems and capital calculation systems should not be fundamentally different, whatever the purpose, internal or regulatory.
  139. Any differences between the ratings and risk parameter estimates used in calculating capital requirements and the final parameters used internally should rely on a well documented rationale. There should be a robust audit trail, adhering to a specified internal policy. The purpose of this policy should be to assess the materiality of differences and whether they lead to conservatism or relaxation in capital adequacy. When pricing margins are calculated using non-IRB data, it would be useful for the institution to sort out both types of margins calculations and include conservatism in the calculation of the regulatory capital requirements. The more numerous the differences between the regulatory and the internal systems, the higher the internal governance standards should be.
  - 139a. For the purpose of the use test, institutions using economic capital models should provide explanations about differences in the data and parameters used in the economic capital model and those used to calculate regulatory capital requirements.
  140. In areas relating to the credit risk assessment process (ratings, etc.) the final parameters used for internal purposes and the data used in calculating capital requirements are expected to be in line. On the other hand, some flexibility is seen as possible for pricing and internal capital allocation. No internally used final default or loss estimate should render the estimate used in the calculation of capital requirements implausible.
  141. Inputs identified as major for credit risk selection, estimation, and/or management for internal purposes should not be set aside for assigning ratings and estimating risk parameters used in the

- calculation of capital requirements. The source of information and related analysis should not be missing from the criteria used for regulatory rating and PD estimation purposes.
142. Special attention will be given to LGDs and CFs. These parameters must have been estimated and used in a broadly consistent manner for three years prior to permission being granted. This period may be reduced to no less than two years until 31 December 2008, during the experience test (see below), and during the use test in a fully consistent manner for a period appropriate to ensure accuracy and consistency of those estimates according to Article 84(2) (b) before their usage for calculation of regulatory capital requirements can be validated.
  143. The model(s) should be consistent with the institution's strategy and technology plans. Risk parameter estimates and modelling should be as accurate as possible, reflecting the different types of exposures in portfolios and sub-portfolios. The institution may have to develop various rating systems, and in such cases the use test should be applied accordingly.
  144. Many institutions use master scales for internal risk management. While supervisors recognise their usefulness for this purpose (ensuring equivalent risk categories across portfolios), the correct calibration of each individual rating system is more important than their link to the common master scale, as the capital requirements depend on the correctness of this calibration.
  145. Strategic plans should provide for extensive training to help the institution's personnel, including senior management, understand the institution's rating model(s). The complexity of the model(s), the internal and external processes used by the institution to operate the model(s), and how the ratings produced should be used need to be well understood. Efforts made to implement the CRD are to be assessed from this perspective, particularly when institutions use statistical models to assign ratings and estimate risk parameters. The effective operation of models has significant human resource and technology implications which should be coordinated by a strategic plan that takes into account the impact of the model on the various functional areas of the institution.

### **Experience test**

146. Article 84(3) and (4) of the Directive 2006/48/EC requires at least three years prior use of rating systems that are broadly in line with the minimum requirements of the CRD before regulatory use is authorised (experience test).

147. Until 31 December 2009, the three-year period can be reduced to no less than one year for institutions applying for the use of an IRB approach before 2010. This provision applies to the experience test for rating systems; it also refers to the retail exposure class. For institutions applying for the use of own estimates of LGDs and conversion factors for the central governments and central banks, institutions, and corporate exposure classes, this period can, until 31 December 2008, be reduced to no less than two years (experience test with own estimates for LGDs and conversion factors for non-retail exposures).
148. The experience test under Article 84(3) and (4) has a more restrictive scope than the use test. It only refers to processes and functions relating to risk measurement and management purposes and requires rating systems only to be broadly in line, and estimates only to be broadly compliant with the minimum requirements. The use test covers more processes and functions, and ultimately requires the complete rating system to be used for the IRB approach. In the experience test, the length of prior use is considered key, because it takes some time for an appropriate and homogenous use to be reached.
149. Supervisors will expect a good mix between scope, experience test, and internal use of data. This use-test trade-off is to be reached prior to implementation of an IRB approach for a particular type of exposure.

### **3.3. Methodology and documentation**

#### **3.3.1. Assignment to exposure classes**

150. The CRD accords preferential capital treatment to certain types of exposures, especially the Retail (including the Qualifying Revolving Retail) exposure class. To avoid regulatory arbitrage, supervisors will therefore carefully assess institutions' assignment of their exposures to the respective exposure classes.

##### **3.3.1.1. Retail exposure class**

###### **3.3.1.1.1. Individual persons and SMEs**

151. The retail exposure class includes exposures to individual persons and small and medium sized entities (SMEs). It is important to distinguish between SMEs in the retail exposure class and SMEs in the corporate exposure class. Within the retail exposure class, individual persons need to be distinguished from SMEs, as in the latter case the exposure must not exceed EUR 1 million in order to be able to be assigned to the retail exposure class. The institution should take reasonable steps to verify that the EUR 1 million criterion is met.

152. Article 86(4) of the [Directive 2006/48/EC](#) lists four criteria, all of which must be met in order to assign an exposure to the retail exposure class:

- (a) they shall be either to an individual person or persons, or to a small or medium sized entity, provided in the latter case that the total amount owed to the credit institution and parent undertakings and its subsidiaries, including any past due exposure, by the obligor client or group of connected clients, but excluding claims or contingent claims secured on residential real estate collateral, must not, to the knowledge of the credit institution, which must have taken reasonable steps to confirm the situation, exceed EUR 1 million;*
- (b) they are treated by the credit institution in its risk management consistently over time and in a similar manner;*
- (c) they are not managed just as individually as exposures in the corporate exposure class;*
- (d) they each represent one of a significant number of similarly managed exposures.*

153. To comply with Article 86(4)(a), institutions should have internal criteria for distinguishing individual persons from SMEs. If an entity is separately incorporated, this should be seen as strong evidence that the entity is to be regarded as an SME. Other criteria could depend on how the institution manages its loans. For example:
- a. If the institution manages its retail exposures on a transaction basis, the criterion should be the purpose of the loan. In this case, only loans to natural persons for non-commercial purposes should be regarded as exposures to individual persons.
  - b. If the institution manages its retail exposures on an obligor basis, it needs a consistent rule on how to distinguish clients. One option could be to classify a client as an SME if the majority of his or her income is generated by self-employment. Another possibility is to treat any entity that is not incorporated as an individual person.
154. To a certain extent, the EUR 1 million threshold can be handled flexibly. In particular, institutions should distinguish between temporary and permanent violations.
- a. **Temporary violations:** This refers to situations where the threshold is exceeded only temporarily due to short-term variations in exposures, and the violation is immaterial. 'Immaterial' refers in this context to the number and size of individual violations relative to the EUR 1 million threshold. In any case, institutions need clearly defined internal rules specifying the circumstances in which clients may remain in the retail exposure class despite the fact that their exposure exceeds the EUR 1 million limit. That limit should be monitored and documented.  
These exposures can remain in the rating system for retail exposures. For calculating the capital requirement, there are two possibilities. One is to use the retail risk weight curve. However, as a prudential measure, the use of retail rating systems but the corporate risk weight curve is recommended.
  - b. **Permanent violations:** In this case, the exposure should be moved to the corporate exposure class and the corporate curve should be used to calculate the capital requirement. If the rating system applied to the retail exposure class fulfils the requirements for rating systems in the corporate exposure class, no change in the rating system is required. Otherwise, the rating system for corporate exposures should be applied.
155. The EUR 1 million threshold for SMEs should be applied both at the level of the EU parent institution on a consolidated basis, and at the subsidiary level for the application of solo requirements. Supervisors

will expect institutions to be able to identify and consolidate groups of connected clients and to aggregate relevant exposures of each group of connected clients. This identification and aggregation of amounts owed by an obligor client or by a group of connected clients need to be performed with justifiable efforts across all entities of the banking group, unless explicitly excluded by Article 86 (4) of the [Directive 2006/48/EC](#).

156. Consultation with the industry indicates that at the beginning of 2006 not all institutions are capable of satisfying this requirement. Institutions should take reasonable steps to identify and aggregate exposures. Minimum thresholds on individual exposures could be introduced, meaning that only if an individual exposure is above a certain minimum amount should the institution actually check whether the aggregate exposure to the group of connected clients exceeds the EUR 1 million threshold.
157. When the total amount owed is reduced (e.g. amortised) and is less than EUR 1 million, no automatic assignment to the retail exposure class should be applied. In this case, the requirements of Article 86(4)(b) to (d) become paramount.
158. If a parent institution has subsidiaries that are direct creditors to a group of connected clients, a process should be in place that will allow proper assignment of these connected clients to the retail or to the corporate exposure class, based on the aggregate exposure.
159. Institutions shall demonstrate that exposures in the retail exposure class are treated differently – meaning less individually – than exposures in the corporate exposure class (see Article 86(4)(c) of the Directive 2006/48/EC). For this purpose, the credit process can be divided into the following components: marketing and sales activities, rating process, rating system, credit decision, Credit Risk Mitigation methods, monitoring, early warning systems, and workout/recovery process. As long as an institution can demonstrate that any of these components differ clearly, this requirement can be regarded as met.
160. Differences in the rating systems and in the recovery process used by the institution can provide strong evidence that the criterion is fulfilled. Syndicated loans should not be treated as retail, as the syndication of a loan is itself a strong form of ‘individual’ loan management.
161. However, this should not give institutions an incentive to adapt their risk management processes to a lower standard in order to fulfil this criterion. The institution should not change the treatment of an exposure in preparation for the IRB approach.

162. If the rating system is the same as for corporate exposures, it should be possible to validate the rating system for exposures 'treated as retail' on a stand-alone basis. The parameter estimates and capital requirement calculations for retail may also be derived on a pooled basis and not only on the individual parameter estimates for individual obligors in the corporate exposure class. The fact that a retail customer is assigned an individual rating should not by itself exclude classification of that exposure as belonging to the retail sector.

### **3.3.1.1.2. Qualifying revolving retail exposures**

163. Annex VII, Part 1, Paragraph 13 of the Directive 2006/48/EC lists five conditions (indents (a) to (e)), which exposures must meet in order to be assigned to the qualifying revolving retail (QRR) exposure class.
164. The term 'individuals' used in indent (a) is equivalent to 'individual persons' in Article 86(4)(a). The term 'revolving' used in indent (b) is explained sufficiently in the indent.
165. Indent (b) provides that loans must generally be unsecured in order to be included in the QRR exposure class. However, loans in this exposure class may be secured by a general lien that is contractually part of various exposures on the same obligor, as long as the individual exposure is treated as unsecured for capital calculation purposes (i.e., recoveries from collateral may not be taken into account in estimating LGD). The phrase *"if the terms permit the credit institution to cancel them [the undrawn commitments] to the full extent allowable under consumer protection and related legislation"* should be interpreted as follows: an undrawn credit line is considered 'immediately cancellable' even if consumer protection or related legislation prohibit the institution from cancelling it immediately or set minimum cancellation periods. Compliance with consumer protection regulation should not prevent institutions from classifying exposures that comply with all other criteria as qualifying revolving retail exposures.
166. The threshold in indent (c) may be applied at the level of the institution. Subclasses within this exposure class should be differentiated if their loss rates differ significantly. Examples are credit cards, overdrafts, and others.
167. The demonstration of the low volatility of loss rates mentioned in indent (d) should be made at least in the course of the IRB approval process, and afterwards at any time on request. The benchmark level for assessing the volatility of loss rates of the QRR portfolio or sub portfolios relative to the average level of loss rates should in general be the relative volatility of loss rates of other sub portfolios in the so-called 'other retail' exposure sub class, in which the

institution holds exposures. In this case, institutions should provide data on the mean and standard deviation of the loss rates for all those sub-portfolios. When no 'other retail' exposure sub-class is available in the institution or should this sub-class not be appropriate as a benchmark level, the QRR portfolios of peer institutions, mortgage portfolios, or corporate portfolios may serve as possible alternative reference portfolios.

168. An example of a suitable measure of volatility could be the coefficient of variation (the standard deviation divided by the mean), as it normalises the standard deviation by the mean. Loss rate could be defined as the realised loss within a fixed period of time, measured as percentage of the exposure class value. For the purpose of this test, institutions should use the definition of loss provided in paragraphs 198 and 199 of these guidelines. However, if such definition is too burdensome to be used (for example, for losses incurred before implementation of the CRD), Supervisors may allow for the purposes of paragraph 167 the use of a different definition of loss not strictly in accordance with that used in IRB calculation, provided it is applied on a consistent basis. .

#### **3.3.1.1.3. Retail exposures secured by real estate collateral**

169. Annex VII, Part 1, Paragraph 12 of the Directive 2006/48/EC states that for retail exposures secured by real estate collateral, a correlation (R) of 0.15 shall replace the figure produced by the correlation formula in Paragraph 9. Any retail exposure to which the institution assigns real estate collateral for its internal risk measurement purposes should be classified as an exposure secured by real estate collateral. For retail exposures to which no real estate collateral has been assigned, potential proceeds from the value of real estate must not be considered for LGD estimation.

#### **3.3.1.2. Corporate Exposure class**

##### **3.3.1.2.1. SMEs in the corporate exposure class**

170. In Annex VII, Part 1, Paragraph 5 of the Directive 2006/48/EC, which requires institutions to substitute total assets for total sales in the modified correlation formula for SME exposures when total assets is a more meaningful indicator of firm size, the term 'sales' can be defined as total gross revenue received by a firm from selling goods and services in the normal course of business. For some industries, 'sales' needs to be defined more exactly. For example, insurance companies' sales should be defined as gross premium income. It is not necessary to come up with uniform definitions, as country specificities may be important.
171. The CRD requires substituting assets for sales when this is a more meaningful indicator. Substitution on a voluntary basis may be possible when the institution can present evidence that this is at

least an equivalently conservative approach and is applied consistently over time and laid down in its internal rules.

### **3.3.1.2.2. Specialised Lending**

172. Specialised Lending (SL) exposures form a sub-class of the corporate exposure class. These exposures are characterised by a strong linkage between pledged assets and the payments that service the loan.
173. Specialised Lending exposures within the corporate exposure class possess the following characteristics, according to Article 86(6) of the CRD:
  - (a) The exposure is to an entity which was created specifically to finance and/or operate physical assets.
  - (b) The contractual arrangements give the lender a substantial degree of control over the assets and the income that they generate.
  - (c) The primary source of repayment of the obligation is the income generated by the assets being financed, rather than the independent capacity of a broader commercial enterprise.
174. Not all of these requirements necessarily have to be met to the same full extent. Individual elements of the definition could be somewhat relaxed in order to capture different kinds of exposures. However, all three elements of the Specialised Lending definition should be fulfilled in one way or another, at least in substance. The most critical criterion for SL classification is the criterion that the primary source of repayment is the income generated by the assets.
175. The institution should pay special attention to the definition of Specialised Lending in borderline cases between Specialised Lending and the securitisation framework. Certain items might be classified both as Specialised Lending and as a securitised position. The institution should classify such positions consistently over time.
176. The typical counterparty in a Specialised Lending arrangement is a special purpose entity which takes its own legal form and whose payments are segregated from other entities or from the group. There should be a legal contract between the entity and the assets as regards the income that is generated.
177. The number of assets involved in an arrangement is not important in defining Specialised Lending. What is important is whether or not the pledged assets are the source of repayment of the loan. Similarly, it should not be considered important for the definition whether or not the entity has entered into some kind of long-term lease that contractually cannot be terminated. Although such arrangements

represent a transfer of risk, this does not alter the fact that payments are originating from the same object that is being financed and serves as security.

### **Demonstration of fulfilment of requirements**

178. According to Annex VII, Part 1, Paragraph 6 of the Directive 2006/48/EC, institutions can use PD estimates for their Specialised Lending exposures only if they meet the minimum requirements for the IRB approach. In order to reduce opportunities for regulatory arbitrage, it was considered necessary to apply these minimum requirements at the level of certain defined sub-classes of Specialised Lending, rather than at the level of individual exposures.
179. One possible solution is to use the sub-classes of Specialised Lending defined in the Basel II framework. The Basel Committee specified five sub-classes.<sup>65</sup> It is suggested that Specialised Lending be divided into the four main Basel II sub-classes. The introduction of the fifth sub-class, High-Volatility Commercial Real Estate (HVCRE), shall remain a national option for supervisors. Exceptions from the Basel II sub-classes can be allowed and will be handled flexibly.

### **Application of SL risk weights**

180. Article 87(5) of the Directive 2006/48/EC requires that the risk weighted exposure amount is calculated in either of two different ways.
181. *“Notwithstanding Paragraph 3 [referring to the calculation of risk weights for ordinary corporate exposures], the calculation of risk weighted exposure amounts for credit risk for Specialised Lending exposures may be calculated in accordance with Annex VII, Part 1, Paragraph 6 [referring to the alternative method for Specialised Lending exposures]. Competent authorities shall publish guidance on how credit institutions should assign risk weights to Specialised Lending exposures under Annex VII, Part 1, Paragraph 6 and shall approve institutions assignment methodologies”.*
182. The best way of providing such guidance would be to apply the approach of the Basel II framework. The Basel Committee has already developed ‘Supervisory Slotting Criteria’ for risk-weighting Specialised Lending exposures.<sup>66</sup> These criteria should be used as the primary guidance for European institutions.

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<sup>65</sup> The five Basel II subclasses are Project Finance, Object Finance, Commodities Finance, and Income-Producing Real Estate (these are the main sub-classes), and High-Volatility Commercial Real Estate.

<sup>66</sup> Supervisory Slotting Criteria for Specialised Lending, International Convergence of Capital Measurement and Capital Standards, Annex 4.

183. Risk weights for Specialised Lending exposures are available only to IRB institutions. Institutions that use the Standardised Approach for credit risk are not allowed to use the SL risk weights. Furthermore, the use of the Basel II Supervisory Slotting Criteria requires that the institution has also applied the Basel Framework SL sub-classes, as mentioned above.
184. An institution specialising in certain areas could well wish to refine elements of the provided guidance. This should be allowed as long as the refinements introduce additional elements, but do not replace the elements of the guidance.

### **Application of preferential risk weights**

185. The CRD states that competent authorities may authorise a institution to assign preferential risk weights to highly-rated (categories 1 and 2) SL exposures with remaining maturities of less than 2.5 years, provided the institution's underwriting characteristics and other risk characteristics are substantially strong for the relevant category. In exercising this discretion, supervisors should rely on institutions to demonstrate that the specified requirements are fulfilled and that their rating systems are stricter than the standards.
186. Especially when faced with scarcity of data for the estimation of key risk factors, institutions could be encouraged to apply additional techniques such as various kinds of simulation. However, the institution should collect its own default and loss data, as well as external data when they are representative.
187. The different aspects of Specialised Lending should be reviewed at least annually. This includes the ratings, but also the categorisation of exposures as Specialised Lending and the demonstration that exposures can or cannot be treated within the general IRB framework.

### **3.3.1.3. Securitisation exposure class**

#### **3.3.1.3.1. Definition of securitisation exposure class**

- 187a. Article 86(1)(f) of the [Directive 2006/48/EC](#) identifies securitisation positions as one of the exposure classes of the IRB approach. The provisions for calculating risk-weighted exposure amounts for the securitisation positions exposure class are set out in Articles 94 to 101 of the Directive 2006/48/EC and Annex IX, Part 4, Paragraphs 1 to 5 (general provisions) and 37 to 76 (IRB approach) of the Directive 2006/48/EC. The IRB approach for securitisation positions provides for a Ratings Based Approach and a Supervisory Formula Method (Kirb), the Internal Assessment Approach (IAA) and the fallback approach for eligible liquidity facilities, for which neither the Ratings based approach, nor the IAA nor the Supervisory Formula Method are appropriate to determine a risk weight.

187b. A 'securitisation position' is defined in Article 4(40) of the Directive 2006/48/EC as an exposure to a securitisation, which Article 4(36) defines as *a transaction or scheme whereby the credit risk associated with an exposure or pool of exposures is **tranch**, having the following characteristics: (a) payments in the transaction or scheme depend on the performance of the exposure or pool of exposures; (b) the subordination of tranches determines the distribution of losses during the ongoing life of the transaction or scheme.*

187c. Thus the securitisation exposure class is characterised by three key elements:

- a) 'Tranching' of credit risk. Tranching is central to the nature of a securitisation. In order to fall within the scope of the securitisation framework, the risk transfer should occur through a structure in which the underlying credit risk of the exposures should be sliced and repackaged into at least two tranches at the inception of the transaction reflecting different degrees of credit risk. Any first-loss positions have to be counted as tranches, regardless of whether they are carried on the books as assets. For example, residual payment claims resulting from a refundable purchase discount that may or may not be accounted for initially as 'loss on sale' have to be counted as tranches. Using the terminology of the Basel II framework, a securitisation is a structure in which the cash flow from an underlying pool of credit risk exposures is used to service at least two different stratified risk positions or tranches reflecting different degrees of credit risk.
  
- b) Payments to the investors depend on the performance of the underlying credit risk exposures ('credit link' or 'limited recourse'). This element differentiates securitisations from structures in which the payments are derived from an unconditional obligation of the originating entity, where the 'underlying' exposures serve only to collateralise the borrower's unconditional payment obligation rather than as a means of determining the extent of the obligation.
  
- c) Subordination determines the distribution of losses over the entire lifetime of the transaction. Subordination differentiates securitisation from structures funded with ordinary senior/subordinated debt instruments, for which the priority of rights is set only in the liquidation process. (I.e., senior and subordinated debt both default at the same time, and only the liquidation proceeds are distributed unevenly, while with securitisations, the default of individual tranches might occur at different points in time over the lifetime of the transaction.)

187d. Due to the complex nature of securitisations, the preceding criteria may not resolve all boundary issues. In general, classification as a securitisation should be linked to the economic substance of the transaction rather than to its legal form. If uncertainty remains as to whether or not a transaction is to be considered a securitisation, institutions should consult their national supervisors. In the current state of the securitisation market, a few boundary cases have been identified by institutions, some of which are elaborated upon in more detail in Annex III of these guidelines.

### 3.3.1.3.2. 'Significant risk transfer'

187e. Securitisation positions can be exposures that an institution holds as an investor, a sponsor or exposures that it holds as an originator. In the latter case the rules for calculating the risk-weighted exposure amounts are described in Article 95 of the [Directive 2006/48/EC](#). According to Article 95(1), *where **significant credit risk** associated with securitised exposures has been transferred from the originator credit institution in accordance with the terms of Annex IX, Part 2, that credit institution may:*

*(a) in the case of a traditional securitisation, exclude from its calculation of risk-weighted exposure amounts, and, as relevant, expected loss amounts, the exposures which it has securitised;*

*(b) in the case of a synthetic securitisation, calculate risk-weighted exposure amounts, and, as relevant, expected loss amounts, in respect of the securitised exposures in accordance with Annex IX, part 2.*

187f. According to Article 95(2), where significant credit risk has been transferred from the originator institution, that institution *shall calculate the risk-weighted exposure amounts prescribed in Annex IX for the positions that it may hold in the securitisation. Where the originator credit institution fails to transfer significant credit risk in accordance with Article 95(1), it need not calculate risk-weighted exposure amounts for any positions it may have in the securitisation in question, but the originator will have to calculate risk-weighted exposure amounts for the securitised assets according to the rules for the respective exposure class.*

187g. The requirement for significance of risk transfer has to be clearly separated from the requirement for effective risk transfer. The latter refers primarily to the legal validity and enforceability of the contractual arrangements of the transaction and to the absence of contractual arrangements undermining the risk transfer, and differentiates between 'traditional' and 'synthetic' securitisations. The requirement for significant risk transfer applies to both kinds of securitisation transactions (although it may have to take into account

aspects specific to one kind of securitisation transaction, such as the volume of reserve account to be built up from excess spread, trapped at SPV level, and carried as an asset by the originating institution in traditional securitisation transactions).

- 187h. Annex IX, Part 2 of the [Directive 2006/48/EC](#) provides the qualitative criteria that have to be fulfilled by a securitisation transaction. However, even if a transaction can meet the securitisation definition established in the CRD, it may not be granted the securitisation treatment in Article 95(1) of the Directive 2006/48/EC if the originator institution has not transferred a significant amount of risk to third parties. Assessing the significance of this transfer could involve other criteria than the ones referred to in Annex IX, Part 2.
- 187k. Accounting derecognition of the securitised credit risk exposures is neither a prerequisite for nor evidence of the effectiveness or significance of credit risk transfer for regulatory purposes.

### **Quantitative evaluation remains necessary.**

187l. Supervisors will verify that a significant portion of the credit risk of the pool has been transferred to at least one independent third party at inception and on an ongoing basis. It is difficult at this stage to provide quantitative thresholds for the amount or percentage of credit risk retained, because of the highly specific nature of these transactions. Most supervisors will therefore use a case-by-case approach.

187m. However, a quantitative threshold could be based on the percentage of losses (EL plus UL) retained by the originator in the form of a first-loss tranche (or equivalent). Since the originator typically retains (at least economically) the expected losses that are estimated to occur over the expected lifetime of the transaction, supervisors would expect at least a significant transfer of the unexpected loss. Some supervisors could pay special attention to the transfer of mezzanine tranches (defined, for example, by external ratings) with significant probabilities of loss, while the retention of super-senior tranches with extremely low probabilities of default would not in itself jeopardise compliance with the significant risk transfer requirement. The criteria for expected and unexpected loss transfer could be summarised by the regulatory requirements for these tranches (i.e. Kirb), or – for institutions applying internal economic capital models – on the requirement that those tranches, accounting for most of the institution's internal (economic) capital requirement for the overall structure (for more sophisticated institutions), need to be transferred. For less sophisticated institutions that do not use economic capital models, significant risk transfer could be measured by the portion of Risk-Weighted Exposure Amounts (or any other suitable measurement) represented by retained mezzanine tranches in relation to all mezzanine tranches (this portion should be small).

187n.

187o.

187p.

187q. Even if a securitisation structure is not recognised as a securitisation for the originator (for example, because the risk transfer is not significant), the transferred pieces will be treated as securitisation on the investor's side.

#### **3.3.1.4. Equity exposure class**

##### **Nature of Equity exposures**

187r. Equity exposures are defined on the basis of the economic substance of the instrument. They include both direct and indirect ownership interests, whether voting or non-voting, in the assets and income of a commercial enterprise or a financial institution. Indirect equity interests include holdings of derivative instruments tied to equity interests, and holdings in corporations, partnerships, limited liability companies, or other types of enterprises that issue ownership interests and are engaged principally in the business of investing in equity instruments. An indirect holding in the form of a subsidiary of a corporate need not be taken into account separately, as far as the subsidiary is taken into account when calculating the risk-weighted exposure amount for the direct equity exposure to the corporate. However, this assertion does not imply an exemption with respect to the treatment of CIUs according to Art. 87 (11) and (12) of the Directive 2006/48/EC, which always requires a look-through-approach.

##### **Assignment of exposures to the Equity exposure class**

187s. This section provides guidance on typical instruments that should usually be included in the Equity exposure class. This guidance does not claim to be comprehensive. Supervisors acknowledge that there might be specific structures that, while fulfilling some or almost all of the following characteristics, might in substance be debt and should be classified as such.

187t. Amplifying on Article 86(5) of the [Directive 2006/48/EC](#) and based on the Basel framework provisions relating to the definition of an equity exposure, the following three criteria are useful in determining what instruments are to be considered as equity exposures. An instrument should be assigned to the equity exposure class if it meets all of the following three criteria.

- It is irredeemable in the sense that the return of invested funds can be achieved only by the sale of the investment, the sale of the rights to the investment, or the liquidation of the issuer;
- It does not embody an obligation on the part of the issuer; and
- It conveys a residual claim on the assets or income of the issuer.

As a failsafe, if a debt instrument is structured, subordinated, and managed as an equity, it should be included in the Equity exposure class.

187u. Additionally, the following instruments should be categorised as Equity exposures:

- An instrument with the same structure as an instrument listed in Article 57 a) to c) of the Directive 2006/48/EC
- An instrument that embodies an obligation on the part of the issuer and that meets any of the following criteria:
  - (1) The issuer may defer indefinitely the settlement of the obligation.
  - (2) The obligation requires (or permits at the issuer's discretion) settlement by issuance of a fixed number of the issuer's equity shares.
  - (3) The obligation requires (or permits at the issuer's discretion) settlement by issuance of a variable number of the issuer's equity shares and (all other things equal) any change in the value of the obligation is attributable to, comparable to, and in the same direction as, the change in the value of a fixed number of the issuer's equity shares. For certain obligations that require or permit settlement by issuance of a variable number of the issuer's equity shares, the change in the monetary value of the obligation is equal to the change in the fair value of a fixed number of equity shares multiplied by a specified factor. Such obligations satisfy this condition if both the factor and the referenced number of shares are fixed. For example, an issuer may be required to settle an obligation by issuing shares with a value equal to three times the appreciation in the fair value of 1,000 equity shares. That obligation is considered to be the same as an obligation that requires settlement by issuance of shares equal to the appreciation in the fair value of 3,000 equity shares.
  - (4) The holder has the option to require that the obligation be settled in equity shares, unless either (i) in the case of a traded instrument, the supervisor is satisfied that the institution has demonstrated that the instrument trades more like the debt of the issuer than like its equity, or (ii) in the case of non-traded instruments, the supervisor is satisfied that the institution has demonstrated that the

instrument should be treated as a debt position. In cases (i) and (ii), the institution may decompose the risks for regulatory purposes, with the consent of the supervisor.

- 187v. Debt obligations and other securities, partnerships, derivatives, or other vehicles structured with the intent of conveying the economic substance of equity ownership are considered equity holdings.
- 187w. Equities that are recorded as a loan but arise from a debt/equity swap made as part of the orderly realisation or restructuring of the debt are included in the definition of equity holdings. However, these instruments may not attract a lower capital charge than would apply if the holdings remained in the debt portfolio. This includes liabilities whose return is linked to that of equities. Supervisors may decide not to require that such liabilities be included if they are directly hedged by an equity holding, such that the net position does not involve material risk.
- 187x. Conversely, equity investments that are structured with the intent of conveying the economic substance of debt holdings or securitization exposures would not be considered equity holdings. Supervisors have the discretion to re-characterise debt holdings as equities for regulatory purposes and otherwise to ensure the proper treatment of holdings under Pillar 2. As an example, bonds with hybrid features may not be considered as Equity to the extent that they receive a fixed share of profits and therefore do not satisfy the second criterion in paragraph 187u. Convertible bonds need to be considered in terms of criteria 2 and 4 of paragraph 187u. For convertible bonds and other such instruments at least the equity part should be captured by assigning it to the equity exposure class.

### **Approaches for calculating risk-weighted exposure amounts for equity exposures**

- 187y. Instruments considered as equity exposures are to be included in the Equity exposure class unless they are consolidated or deducted. Where some member countries retain their existing treatment as an exception to the deduction approach, as a national option offered in the Directive, such equity investments by IRB institutions are to be considered eligible for inclusion in their IRB equity portfolios.
- 187z. Investments in significant minority- and majority-owned and controlled commercial entities below the materiality levels retained for deduction following Article 120 of the [Directive 2006/48/EC](#) will be risk-weighted in accordance with the methodology for equities, and no less than 100 percent after Credit Risk Mitigation techniques have been applied. Equity exposures in the trading book are subject to the market risk capital rules.

188. According to Annex VII, Part 1, Paragraphs 17 to 24 of the Directive 2006/48/EC, institutions can use three different approaches to calculate the risk weighted exposure amounts for equity exposures or a combination of them: the internal models approach, the PD/LGD approach, or the simple risk weight approach.
- 188a.
- 188b. When an institution uses more than one approach, Annex VII, Part 1, Paragraph 17 of the Directive 2006/48/EC requires it to demonstrate that this choice is made consistently. Those different approaches should be considered as consistent through the use of different tools and processes reflecting the internal management processes. Different approaches for the calculation of capital requirements alone are not a sufficient criterion for consistency.
- 188c. If the internal models approach is used, this model should be integrated into the risk management process as required by Annex VII part 4 paragraph 115 of the Directive 2006/48/EC. For example, the output of the model should be used by the institution for its investment policy, for setting limits, and for managing exposures
- 188d. The simple risk weight approach (Annex VII, Part 1, Paragraph 19 of the Directive 2006/48/EC) allows a reduced risk weight for private equity exposures in sufficiently diversified portfolios. Institutions might demonstrate sufficient diversification by making reference to the number of investment funds, the number of investments which compose the portfolio and the related funds, or specific indexes to assess diversification, if available. Alternatively, supervisors may choose to set explicit limits on the number of investments in a portfolio for it to be included in the private equity exposure class. Loss history could also be an indication of a sufficiently diversified portfolio for demonstrating that the simple risk weight approach could be applied to the private equity exposure.

### **Permanent exemptions of equity exposures from the IRB treatment**

- 188e. According to Article 85(3) of the [Directive 2006/48/EC](#), institutions using the IRB approach for any exposure class shall at the same time use the IRB approach for the equity exposure class. However, Article 89 provides some exceptions to this rule.
- 188f. Certain equity-like investments can remain outside the IRB treatment. These are:
- (a) Equity exposures to entities whose credit obligations qualify for a zero risk weight under the Standardised Approach, including those publicly sponsored entities where a zero risk weight can be applied (Article 89 (1)(f)).

- (b) Equity exposures incurred under legislated programmes to promote specified sectors of the economy that provide significant subsidies for the investment to the institution and involve some form of government oversight and restrictions on the equity investments (Article 89(1)(g)).

188g. The restrictions referred to in Article 89(1)(g) could involve the size or type of firms, the amounts which can be invested, geographical location, or other factors potentially limiting the risk of the investment.

188h. Article 89(1)(g) limits the aggregate amount of equity exposures incurred under legislated programmes which are permanently exempted from an IRB approach to 10 percent of the institutions' own funds as defined in Article 57 of the Directive 2006/48/EC. This ratio should be calculated according to the method mentioned in paragraph 188i of these guidelines. This limit applies at the level of the minimum own funds requirement, in application of Chapter 2, Section 2, Subsection 1 of the Directive 2006/48/EC.

188i. The entire equity exposure class can be permanently exempted from an IRB approach, if it is immaterial in terms of size and perceived risk profile (Article 89(1)(c)). According to Article 89(2), for the purposes of point (c) of Article 89(1), *the equity exposure class of a credit institution shall be considered material if their aggregate value, excluding equity exposures incurred under legislative programmes as referred to in point (g), exceeds, on average over the preceding year, 10% of the credit institution's own funds. If the number of those equity exposures is less than 10 individual holdings, that threshold shall be 5% of the credit institution's own funds.* Materiality should be measured after the exclusions mentioned in points (a) and (b) of Paragraph 188f. The threshold should be managed on an ongoing basis, and should in any case be checked by the institution at least once a year.

### **3.3.1.5. Purchased receivables**

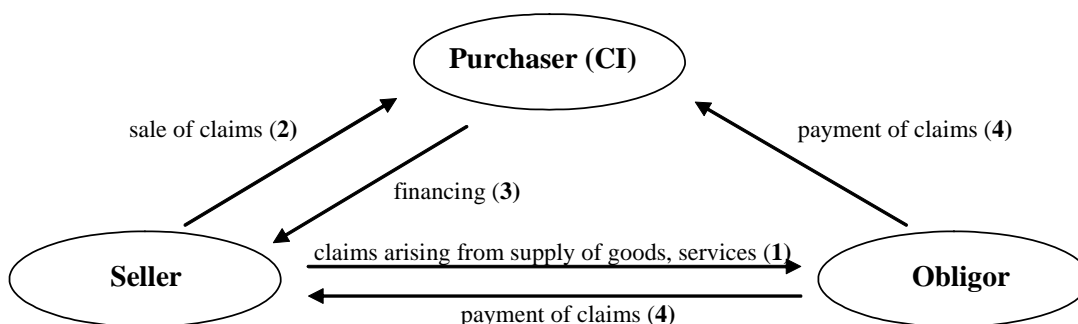
#### *Introduction*

188j. Receivables can be treated under three different types of approaches:

- The exposure is treated as an exposure on the seller and the receivables are treated as collateral, whose eligibility needs to be checked under Annex VIII, Part 2 of the [Directive 2006/48/EC](#).
- The exposure is treated as an exposure on the obligor and it is not unduly burdensome for the institution to assess the risks of each exposure as if the institution had originated the exposure. The seller may or may not act as guarantor.

- The exposure is treated as an exposure on the obligor, and it would be unduly burdensome for the institution to assess the risks of each exposure as if the institution had originated the exposure. This may, in particular, be the case when the institution has to rely to a large extent on information provided by a third party. At times, the institution may not even know each individual obligor. Again, the seller may or may not act as guarantor. The receivables treatment is designed to address the particularities of this third case.

188k. Receivables do not constitute an exposure class in itself, but reflect a type of financing. Receivables transactions may occur within the corporate or retail exposure classes. There are typically three types of financing: factoring, sale of claims over which the institution has legal ownership, and securitised exposures which are not themselves securitization positions. The CRD does not provide a precise definition of purchased receivables. However, purchased receivables transactions involve a 'triangular' relationship between the participants. Factoring, for example, involves an institution, a seller, and an obligor:



188l. The regulatory treatment of purchased receivables is aimed at taking into account, on one hand, the dilution risk that is generally present, and on the other hand, the institution's inability to apply the risk quantification standards for corporate exposures in some cases.

*Definition*

188m. Since the CRD does not provide a precise definition of purchased receivables, supervisors will rely on an economic definition based on the characteristics of the transaction. As noted above, purchased receivables do not constitute an exposure class in themselves; they represent a type of financing, common to more than one asset class, usually arising from the sale of goods and services linked to a

commercial transaction. The purchased receivable rules are intended primarily for receivables which are purchased as part of factoring or invoice discounting, or which are included in (or to be included in) asset-backed transactions. They do not apply to transactions in which loans originated by one firm are subsequently bought by another in order to add obligors to the purchaser's non-securitization business.

Necessary conditions for the treatment of purchased corporate receivables according to the IRB minimum requirements for the retail exposure class

188n. The general IRB minimum requirements set different standards for banks' internal rating systems for corporate exposures compared to retail exposures. While the minimum requirements for rating corporate exposures require detailed information, the requirements for retail can also be met with pooled data. If the standards for corporate exposures were applied to eligible purchased corporate receivables, it would be very difficult for an institution to satisfy the minimum requirements when the obligor is not its customer, let alone when the obligor is not known to the institution. Consequently, even institutions which follow best industry practice with respect to their eligible purchased corporate receivables would find themselves out of compliance with the IRB minimum requirements. To avoid this outcome, the general IRB minimum requirements on rating systems for retail exposures are extended to eligible purchased corporate receivables under the IRB rules for eligible purchased receivables.

188o. Annex VII, Part 1, Paragraph 7 of the Directive [2006/48/EC](#) provides that the risk quantification standards for retail exposures (as set out in Part 4) may be used for purchased corporate receivables that comply with the minimum requirements in Part 4, Paragraphs 105 to 109 and Part 1, Paragraph 14 if it would be unduly burdensome for an institution to use the risk quantification standards for corporate exposures as set out in Part 4 of Annex VII. In order to qualify for this treatment, the burden is on the institution to demonstrate that it fulfils the eligibility criteria defined in the CRD. The meaning of some of those criteria is specified below:

- The exposure that the institution has purchased has not been directly or indirectly originated by the institution itself.
- There should be an arm's length relationship between the seller and the buying institution: i.e., both parties should interact as independent agents in the financial market. Neither of the agents must be in a position to influence the internal decision-making process of the other agent. The requirement for an arm's length relationship between the seller and the buying institution is intended to prevent institutions from bypassing the general IRB minimum requirements on corporate exposures. Institutions that want to treat exposures as eligible purchased receivables should make sure, at a minimum, that:

1. There is no material contagion risk of default between the seller and the institution; and
  2. The receivables have been granted in fully competitive conditions on a level playing field: i.e., at market price and under market conditions.
- The portfolio needs to be sufficiently diversified. One way to implement this requirement could be in terms of the number of obligors. A concentration limit could be set in the form of an absolute limit (exposure size per counterparty) or a relative limit (percentage of the total pool).

188p. If a corporate purchased receivable does not meet all of the above conditions, it will be subject to the general IRB minimum requirements for corporate exposures.

188q. 'Unduly burdensome' in the sense of Annex VII, Part 1, Paragraph 7 of the [Directive 2006/48/EC](#) means that the underlying obligors are so numerous that the institution would not be in a position to rate them using its normal rating system. It could also mean that the obligors are not the institution's usual, direct obligors, and thus the institution's data systems do not contain any specific information on them. A maximum exposure size could be a complementary requirement. When institutions collect enough data to be able to assess obligors at an individual basis, they should abandon the top-down approach for purchased corporate receivables and use the bottom-up approach instead.

#### *Estimating EL for purchased corporate receivables*

188r. Institutions may estimate ELs for purchased corporate receivables by EL grade from long-run averages of loss rates. Institutions using this approach should have a distinct EL rating scale which would enable them to assign obligors or pools of obligors to EL grades.

#### *Dilution risk*

188s. Under the IRB approach, dilution risk has to be covered even when the institution treats the exposure as if the obligor were a customer to the institution.

188t. Article 4(24) of the [Directive 2006/48/EC](#) defines 'dilution risk' as the risk that an amount receivable is reduced through cash or non-cash credits of the obligor. Dilution risk therefore refers to the possibility that the potential amount of receivables bought and financed by the institution may be reduced at the initiative of the seller or the obligor, and that the contractual amounts payable by the receivables obligors may be reduced through cash or non-cash credits to these obligors. Examples include offsets or allowances arising from return of goods sold, disputes regarding product quality, possible debts of

the obligor to a seller, and any payment or promotional discounts offered by the seller, such as a credit for cash payments within 30 days.

188u. In the cases where institutions are in doubt as to whether a particular event should be treated as dilution risk or not, they should treat it as dilution risk. This includes situations where an institution cannot clearly allocate events to operational risk. For Asset-Backed Commercial Paper, dilution risk on the underlying will be assessed pro-rata.

188v. According to Annex VII, Part 1, Paragraph 28 of the Directive 2006/48/EC, a special risk weight needs to be applied for dilution risk. Only when the dilution risk is immaterial (under normal circumstances, immateriality would be assumed for purchased bonds) does it not need to be recognised.

188w. Materiality in this respect could be assessed at the pool level using a specific expected loss examination. In that case, a materiality threshold for expected loss should be set by the institution. This threshold should be conservative, as dilution risk is a true risk driver in this type of financing and institutions should always be prepared to manage it, even if they currently have difficulty in quantifying it.

188y. According to Annex VII, Part 2, Paragraph 7 of the Directive 2006/48/EC, the regulatory EL for dilution risk of purchased corporate receivables can be derived in various ways (e.g., estimation of EL itself and not of PDs or LGDs). The following table summarises the different possibilities under Annex VII, Part 2, Paragraphs 7 and 8(g) of the Directive 2006/48/EC:

| Own estimates |     | PD and LGD to be used in the formula |               |
|---------------|-----|--------------------------------------|---------------|
| PD            | LGD | PD                                   | LGD           |
| yes           | yes | Own estimates                        | own estimates |
| yes           | No  | Own estimates                        | 75%           |
| no            | No  | estimate of EL                       | 100%          |

### 3.3.2. Definition of default and loss

#### 3.3.2.1. Definition of default

188z. The definition of default provided by the CRD focuses on two types of events: "unlikeliness to pay" and "past due status for more than 90 days on a material credit obligation."

189. Annex VII, Part 4, Paragraph 44 of the [Directive 2006/48/EC](#) states that a 'default' shall be considered to have occurred with regard to a particular obligor when either or both of the two following events has taken place:

- (a) *The institution considers that the obligor is unlikely to pay its credit obligations to the institution, the parent undertaking or any of its subsidiaries in full, without recourse by the institution to actions such as realising security (if held).*
- (b) *The obligor is past due more than 90 days on any material credit obligation to the institution, the parent undertaking or any of its subsidiaries.*

189a. In addition, Annex VII, Part 4, Paragraph 44 of the Directive 2006/48/EC states that in all cases the past due exposure shall be above a threshold defined by the competent authorities and which reflects a reasonable level of risk.

190. Annex VII, Part 4, Paragraph 45 of the Directive 2006/48/EC lists the main elements to be taken as indications of 'unlikeliness to pay':

- (a) *The credit institution puts the credit obligation on non-accrued status.*
- (b) *The credit institution makes a value adjustment resulting from a significant perceived decline in credit quality subsequent to the credit institution taking on the exposure.*
- (c) *The credit institution sells the credit obligation at a material credit-related economic loss.*
- (d) *The credit institution consents to a distressed restructuring of the credit obligation where this is likely to result in a diminished financial obligation caused by the material forgiveness, or postponement, of principal, interest or (where relevant) fees. This includes in the case of equity exposures assessed under a PD/LGD Approach, distressed restructuring of the equity itself.*
- (e) *The credit institution has filed for the obligor's bankruptcy or a similar order in respect of an obligor's credit obligation to the credit institution, the parent undertaking or any of its subsidiaries.*

- (f) *The obligor has sought or has been placed in bankruptcy or similar protection where this would avoid or delay repayment of a credit obligation to the credit institution, the parent undertaking or any of its subsidiaries.*

191. The definition of default used to estimate risk parameters should be the same, regardless of the parameter for which it is used (PD, CF, LGD, or EL). However, the specific requirements of the CRD for the adoption of a compliant definition of default apply only for the purpose of risk quantification.

### **Definition of default within the same country**

192. The definition of default adopted by different institutions within the same country shall be based on the regulatory definition of default. At a minimum, the institution should implement, in addition to the objective criteria based on the number of days past due, a definition of default based on the indications of unlikelihood to pay (see Paragraph 190) that are applicable under the country's legal regimes. The institution should interpret the indicators and their relevance in accordance with its own practices and market characteristics.

193. Institutions should also take into account other indications of unlikelihood to pay that are suited to their obligors and facilities or the specificities of their market. These indications should be used in addition to the ones listed above, not as substitutes. Additional criteria could be necessary to make the full set of criteria more specific and detailed. They should be formalised and well documented in institutions' internal guidelines, in order to allow third parties (such as Internal Audit or supervisors) to carry out checks on the number of defaults identified. To prevent arbitrage and/or gaming possibilities, supervisors should carefully assess the definition of default adopted by each institution, evaluating those criteria with respect to the institution's internal practices.

194. For guidance on the use of external data sets that are based on different definitions of default, see section 3.4.3. below on 'representativeness of data used for model development and validation.'

### **Past due exposures, materiality of credit obligations when past due**

195. The materiality concept referred to in the 'past due' criterion is interpreted as a way to avoid counting obligors as defaulted when they are past due merely for technical reasons or the amount in past due status is negligible. The materiality thresholds defined by the supervisors provide a minimum criterion for institutions, with the aim of obtaining a minimum definition of default that will be

algorithmically describable. Thresholds may be set by the competent authorities for all the institutions in their jurisdiction ('one-size-fits-all' rule), or on a case-by-case basis, supported, if necessary, by a qualitative assessment.

196. In addition to the threshold set by the supervisors, institutions might take into account other indications for the materiality of past due amounts that are suited to their obligors and facilities or the specificities of their market. However, such indications should be used in addition to the ones mentioned above, not as substitutes. When setting internal materiality thresholds, an assessment of the 'cure rate' – i.e., the fraction of past due obligors that return to a non-defaulted status without the intervention of the institution – should be carried out by the institution, in order to avoid counting obligors as defaulted that are in past due status merely for technical reasons and hence generating artificially low LGDs.

### **Default of individual entities vs. default of groups**

197. As a general rule, the rating assignment process and the definition of default adopted should be consistent. Contagion of default between linked parties should be carefully assessed. For example, if a rating is assigned to the entire group to which the individual borrowing entity belongs (e.g., if it is based on the consolidated balance sheet, and the 'rated entity' is thus the group), then the default status should be triggered accordingly (i.e., for the whole group as a single rating object), unless the institution can demonstrate that default at the subsidiary level does not have material consequences for the stability of the group as a whole. In these cases, however, supervisors might question whether a group rating was appropriate.

#### **3.3.2.2. Definition of loss**

198. For the purpose of determining minimum capital requirements for credit risk, the [Directive 2006/48/EC](#) defines loss and Loss Given Default (LGD) in Article 4(26) and (27), and dedicates a specific section (see Annex VII, Part 4, section 2.2.2,) to the requirements specific to own LGD estimates. The definitions are based on the concept of economic loss (Article 4(26)), which includes material discount effects and material direct and indirect costs associated with collecting on the instrument.

#### *Data for economic loss*

199. The Loss Given Default (LGD) is the ratio of the loss on an exposure due to the default of a counterparty to the amount outstanding at default (Article 4(27)). The data used to calculate the realised LGD of an exposure (see also the definition provided in paragraph 217 of these guidelines) should include all relevant information. This could include, depending on the type of the exposure:

- The outstanding amount of the exposure<sup>67</sup> at the time of default (including principal plus unpaid but capitalised interest and fees).
  - Recoveries, including the income and sources of recoveries (e.g., cash flows from sale of collateral and guarantee proceeds or realised income after the sale of defaulted loans).
  - Work-out costs, including material direct and indirect costs associated with work-out collection. Such work-out costs could stem from the cost of running the institution's work-out department, the costs of outsourced collection services directly attributable to recoveries such as legal costs, and also an appropriate percentage of other ongoing costs such as corporate overheads.
  - As far as needed for calculating material discount effects, the dates and the amounts of the various cash flows that were incurred ('timing of the recovery process').
200. Institutions should collect and store data to assess LGDs, including recovery and work-out costs. This information should be collected at the level of each defaulted exposure or each pool (when necessary in the retail exposure class). Over time, institutions should collect work-out costs at as granular level as possible. If institutions only have data at an aggregate level, they should develop a proper allocation methodology.

*Use of external data of economic loss*

201. The less internal information the institution has for estimating LGDs (also in terms of representativeness of the defaulted portfolio), the more important is the use of external data (including pooled data) and multiple data sources (e.g., the combination of external and internal data) for improving the robustness of LGD parameter estimation. In particular, appropriate external benchmarks, if available, should be considered by the institution. The institution should carefully evaluate all relevant external data and benchmarks, as some data on components of loss are typically country-specific (for example, the potential inability to gain control over collateral depends on national legal frameworks) or institution-specific (for example, collection processes leading to variations in work-out costs, other direct costs, and indirect costs). In other cases, some components of economic loss might not be included in the external data. The institutions should analyze the loss components of the external data and the comparability of external data with respect to its lending practices and internal processes, and should take into account the results of these analyses during the estimation process. (See also section 3.4.4. on data sources.)

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<sup>67</sup> For the different possibilities for calculating exposure values, see Annex VII, Part 3 of the Directive 2006/48/EC.

## *Discount rate*

202. The discount rates used by institutions to incorporate material discount effects into economic loss may vary depending on the respective market, the kind of facility, or the institution's work-out practices for defaulted facilities.
203. The measures of recovery rates used in estimating LGDs should reflect the cost<sup>68</sup> of holding defaulted assets over the workout period, including an appropriate risk premium. When recovery streams are uncertain and involve risk that cannot be diversified away, net present value calculations should reflect the time value of money and an appropriate risk premium for the undiversifiable risk. In establishing appropriate risk premiums for the estimation of LGDs consistent with economic downturn conditions, the institution should focus on the uncertainties in recovery cash flows associated with defaults that arise during an economic downturn. When there is no uncertainty in recovery streams (e.g., recoveries are derived from cash collateral), net present value calculations need only reflect the time value of money, and a risk-free discount rate is appropriate.
204. Measures of recovery rates can be computed in several ways: for example,
- By discounting the stream of recoveries and the stream of workout costs by a risk-adjusted discount rate which is the sum of the risk-free rate and a spread appropriate for the risk of the recovery and workout cost cash flows,
  - By converting the stream of recoveries and the stream of workout costs to certainty-equivalent cash flows<sup>69</sup> and discounting these by the risk-free rate, or
  - By a combination of adjustments to the discount rate and adjustments to the streams of recoveries and workout costs that is consistent with this principle.<sup>70</sup>

The process for arriving at a discount rate should be consistent for all exposures of the same kind. Institutions should justify this point carefully, to ensure the absence of any arbitrage caused by manipulating discount factors. Whenever they apply a risk-free rate, they should demonstrate to their supervisors that any remaining risk is covered elsewhere in the calculation.

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<sup>68</sup> The concept of cost referred to here must be consistent with the concept of economic loss as described in paragraph 198.

<sup>69</sup> A certainty-equivalent cash flow is defined as the cash payment required to make a risk averse investor indifferent between receiving the cash payment with certainty at the payment date and receiving an asset yielding an uncertain payout whose distribution at the payment date is equal to that of the uncertain cash flow.

<sup>70</sup> An institution may use an 'effective interest rate' as the discount rate in accordance with IAS 39, but in that case it should adjust the stream of net recoveries in a way that is consistent with this principle.

### *Allocation of direct and indirect costs*

205. Work-out and collection costs should include the costs of running the institution's collection and work-out department, the costs of outsourced services, and an appropriate percentage of other ongoing costs, unless an institution can demonstrate that these costs are not material.
206. An institution should demonstrate that it collects in its databases all information required to calculate material direct and indirect costs. The cost-allocation process should be based on the same principles and techniques that institutions use in their own cost accounting systems. These might include (among others) methods based on broad averages, or statistical methods based on appropriately chosen samples within a population of defaulted obligors. Institutions should demonstrate that the cost-allocation process is sufficiently relevant and rigorous. Institutions should also define 'materiality' and document the cost elements in a consistent way over time.

### **3.3.3. Rating systems and risk quantification**

#### **3.3.3.1. Probability of Default (PD)**

207. The first parameter used in the supervisory formula for calculating regulatory capital requirements for credit risk is the Probability of Default. According to the CRD, IRB institutions are expected to have rating systems which:
  - Assign obligor/exposure risk ratings and validate the accuracy of those ratings (Annex VII, Part 4, Paragraphs 5 to 29 of the Directive 2006/48/EC).
  - Translate risk ratings into IRB parameters, specifically for estimating probabilities of default (Annex VII, Part 4, Paragraphs 30 and 49 to 72 of the [Directive 2006/48/EC](#)).

#### **Rating Assignment methodology**

208. The supervisor will assess institutions' processes for validating their rating assignment methodologies and the adequacy of those validation processes.
209. This assessment will cover the institution's understanding and analysis of the rating assignment methodologies, the obligor rating system, its logic, and its ability to provide meaningful differentiation of risk. In practice, institutions use a variety of different rating assignment methodologies to assign obligor grades. Institutions can combine various methodologies for assigning obligor grades (for example, they can combine statistical models with expert judgement systems.) Institutions shall present the assumptions underlying their models or methods, and justify them to the supervisors.

210. Statistical methods may be used to quantify compliance with Annex VII, Part 4, Paragraph 30 of the Directive 2006/48/EC. Regardless of the methodology used to assign obligor grades, institutions shall demonstrate to supervisors that rating assignments and ratings systems for obligor default risk comply with the minimum requirements in Annex VII, Part 4 of the Directive 2006/48/EC.
211. The supervisors' assessment of the institution's rating assignment methodology shall focus on the following issues:
- The part of the rating system structure within which the rating assignment methodology is being used (Annex VII, Part 4, Paragraphs 4 to 18 of the Directive 2006/48/EC).
  - The underlying rationale/theory (e.g., main assumptions, rating philosophy) used in developing the rating assignment methodology.
  - If multiple methodologies are used for a single class of exposures or a single portfolio, the boundary-effects analysis that is applied (i.e., how a borrower would be rated by another 'neighbouring' rating model, particularly if its assignment to the first rating model was a close decision, and its assignment to the 'neighbouring' model would have been a close decision, too).
  - The institution's regular process for validating the performance of the assignment methodology.
  - Detection of any deficiencies in the rating system for obligor default risk that need to be corrected by the institution.

### **PD estimation methodology**

212. The supervisor will assess institutions' processes for validating their PD estimation methodologies and the adequacy of those validation processes.
213. This assessment will cover the institution's understanding and analysis of the logic of PD estimation, and its accuracy. If institutions use direct estimation methods (see Annex VII, Part 4, Paragraph 4 of the Directive 2006/48/EC), there may be some overlap between the assignment of obligors to rating grades and the estimation of PDs for the respective rating grades. In this case, all of the requirements for the rating assignment methodology apply to PD estimation as well. Institutions may use different estimation methods (and different data sources) to estimate PDs for obligor rating grades or pools, including mapping internal rating grades to the scale used by an ECAI in order to attribute the default rates observed by this ECAI to internal rating grades, statistical default prediction models, or other estimation methods or combinations of methods.
214. Regardless of the type of estimation method used, institutions shall demonstrate to supervisors that the estimation of PD complies with the minimum requirements set out in the Directive 2006/48/EC. The

supervisors' assessment of the institution's estimation methodology shall focus on the following issues:

- The methods used for estimating PD.
- The compliance of the definitions of default used in calibrating PD with the regulatory definition of default.
- The institution's process for validating the accuracy and predictive ability of estimated PDs.
- Detection of any deficiencies in the estimation system that will need to be corrected by the institution.
- In the case of direct estimates (Annex VII, Part 4, Paragraph 4 of the Directive 2006/48/EC), all of the issues related to the assessment of assignment methodology apply.

### **3.3.3.2. Loss Given Default (LGD)**

215. The second parameter used in the supervisory formula for calculating regulatory capital requirements for credit risk is Loss Given Default. The Directive 2006/48/EC refers to LGD estimation at various points. The overall requirements for IRB approaches of which LGD forms a part are set out in Article 84(2). The relevant requirements for the assignment methodology are laid down in Annex VII, Part 4, Paragraphs 1 to 4, 9, 10 to 11, 13 to 18, and 30. The general requirements for the estimation methodology are laid down in Annex VII, Part 4, Paragraphs 49 to 52 and 54. The requirements for estimation methodology that are specific to LGD are laid down in Annex VII, Part 4, Paragraphs 73 to 80 and 82 to 83.

### **Definitions**

216. The LGD calculation should be based on the definitions of default and economic loss used by the institution, which should be consistent with the provisions contained in the CRD (see also section 3.3.2.2.).
217. It is important to distinguish between realised LGDs and estimated LGDs. Realised LGDs are the total observed losses discounted to the time of default for each defaulted exposure in the data set. The raw data for calculating loss originate in the collection department (for example, recoveries, realisation of collateral, and all cash flows), the accounting department (unpaid but capitalised interest, amount outstanding at the time of default), or other departments. Many institutions using an Internal Rating Based approach record these raw data in a financial data warehouse. All information needed to calculate economic loss should be collected. No filters should be applied at this stage. The data warehouse may feed a database of observed cash-flows which is used to calculate economic loss. Realised LGDs are ex-post values that can be applied to a facility grade or pool.

218. The institution assigns estimated LGDs to its current facilities (both defaulted and non-defaulted) and uses them to calculate the capital requirements for its exposures. Estimated LGDs are based on the realised LGDs for the applicable Reference Data Set (RDS). However, estimated LGDs are likely to differ from the average realised LGDs in the RDS because the former needs to incorporate expectations of future recovery rates. This involves calculating a long-run forward-looking recovery rate for the facility grade or pool, taking both current and future economic circumstances into account. The institution should produce an LGD estimate appropriate for an economic downturn ('downturn LGD') if this is more conservative than the long-run average. Other adjustments may also be necessary. If an institution adjusts a realised LGD, it needs to demonstrate that this adjustment is appropriate and is adequately taken into consideration in its backtesting procedures.
219. According to Annex VII, Part 1, Paragraph 28 and Annex VII Part 4, Paragraph 79 of the [Directive 2006/48/EC](#), an institution must also produce a best estimate of expected loss for defaulted exposures given current economic circumstances and exposure status. The difference between this amount and the estimated LGD derived from the RDS stems from the possibility of additional losses during the recovery period, and represents the Unexpected Loss capital requirement for the defaulted exposure.
- 219a. According to Annex VII, Part 4, Paragraph 74 of the Directive 2006/48/EC, institutions shall use LGD estimates that are appropriate for an economic downturn if those are more conservative than the long-run average. The potential for realised recovery rates to be lower than average during times of high default rates may be a material source of unexpected credit losses for some exposures or portfolios. Failing to account for this possibility risks understating the capital required to cover unexpected losses (for details of assessing the effects, if any, of downturn conditions on recovery rates see paragraph 239a).
- 219b. Accordingly, in order to deal with possible adverse dependencies between PD and LGD, LGD parameters need to embed forward-looking recovery rates on exposures that default during conditions where credit losses are expected to be substantially higher than average. Under such conditions default rates are expected to be high, so that if recovery rates are negatively related to default rates, LGD parameters must embed forecasts of future recovery rates that are lower than those expected during more neutral conditions. In those cases where future recovery rates are expected to be independent of future default rates, there is no supervisory expectation that the forward-looking forecasts of recovery rates embedded in LGD parameters will differ from those expected during more neutral conditions.

## High level principles

220. LGD estimates should reflect the experience and practices of the individual institution as well as the external environment in which it operates. One consequence of this is that institutions cannot rely on industry-wide estimates without adjusting them to reflect their own position where necessary.
221. Since a given percentage variation in LGD estimates results in an equal percentage change in capital charges, any approximation and/or shortcut that the institution decides to adopt should form an important aspect of validation and assessment.

## Data

222. A key step in estimating any IRB parameter is preparing the Reference Data Set (RDS) for that parameter. This involves a variety of challenges, including choosing the sample size, the length of time series, reliance on external data, the treatment of defaulted positions that have generated no loss, and the length of recovery processes (incomplete workout). The institution could need to update some information contained in the RDS. The RDS for LGD should contain at least the following elements:
  - Unlike the RDS for PD estimation, it should include only exposures to defaulted obligors.
  - It should include factors that can be used to group the defaulted facilities in meaningful ways.
223. Ideally, it should:
  - Cover a period that is sufficiently long to include at least one business cycle.
  - Contain all defaults that have occurred within the considered time frame.
  - Contain data for calculating realised LGDs.
  - Include all relevant information needed to estimate the risk parameters.
  - Include data on the relevant drivers of loss.
224. The institution should ensure that the RDS remains representative of its current portfolios.
225. Some defaulted positions may generate no loss, or may even have positive outcomes in the recovery process. The treatment of these events should take into account the following:

- A clear distinction must be made between realised LGDs and estimated LGDs as a parameter for calculating risk weighted exposure amounts. The realised LGD might be zero: if an exposure is cured with no material direct or indirect cost associated with collecting on the instrument, and no loss caused by material discount effects (for example, if the default was caused solely by the 90 day past due criterion, and payment obligations were subsequently completely fulfilled), no loss might occur.
- In cases of low or zero estimated LGD, institutions should demonstrate that their estimation processes are pertinent and accurate. In particular, they should be able to provide concrete evidence of all factors taken into account in the quantification process that gave rise to the low estimates, such as the discount rate, the estimated value of the collateral, the structure of the cash flows, etc.
- Even if positive outcomes in the recovery processes have been observed and can be explained, the estimated LGD used to calculate capital requirements must not be less than zero. It may be zero in exceptional cases. Institutions should demonstrate that they monitor and record positive outcomes of recovery processes to make sure that no systematic errors have been made.
- The treatment of zero-loss facilities should be examined to ensure that it does not result in any distortions. For example, a significant number of zero-loss facilities may indicate, that the institution uses an inappropriately early definition of default or that the RDS contains some facilities which are not true defaults (for example, technical defaults such as small outstanding charges on repaid loans).

## **Risk drivers**

226. While there might be significant differences in LGD estimation methods across institutions and across portfolios, a common set of risk drivers that institutions should take into account in the estimation process can be identified (see Annex VII, Part 4, Paragraph 49 of the Directive 2006/48/EC). These drivers can be grouped in five categories:

1. Transaction-related, including facility type, collateral, guarantees from third parties, seniority, time in default, seasoning, Loan-to-Value (LTV), and recovery procedures;
2. Borrower-related, including borrower size (as it relates to transaction characteristics), exposure size, firm-specific capital structure (as it relates to the firm's ability to satisfy the claims of

its creditors in the event that it defaults), geographic region, industrial sector, and line of business;

3. Institution-related, including internal organisation and internal governance, relevant events such as mergers, and specific entities within the group dedicated to recoveries such as 'bad credit institutions';
  4. External, including interest rates and legal framework (and, as a consequence, the length of the recovery process); and
  5. Other risk factors.
227. This list is neither prescriptive nor comprehensive, and cannot reflect the specific features of the business of individual institutions or the environment in which they operate. Each institution is responsible for identifying and investigating additional risk drivers that are relevant to its specific circumstances. Institutions should collect data on what they consider to be the main drivers of loss for a given group of facilities, and should include the most material drivers in their LGD estimation process. The institution's judgements as to which risk drivers are most material should be appropriately documented and should be discussed with supervisors.

### **Estimation methodologies**

228. In principle, supervisors do not require any specific technique for LGD estimation (or for estimating other IRB parameters). However, institutions will have to demonstrate that the methods they choose are appropriate to the institution's activities and the portfolios to which they apply. The theoretical assumptions underlying the models should also be justified. The CRD does not permit the use of estimates based purely on judgemental considerations.
229. An institution should choose a technique or a combination of techniques for quantifying estimated LGD. The four main alternatives are Workout LGD, Market LGD, Implied Market LGD, and Implied Historical LGD. The latter two techniques are considered implicit because they are not based directly on the realised LGD of defaulted facilities. The analysis of methods provided below does not relieve institutions of their responsibility to conduct their own analysis of which of the methods (if any) best fits their business, or whether some other method might be more appropriate.
230. In the Workout LGD technique, the cash flows resulting from the workout and/or collections process, properly discounted, are calculated. Calculations for the exposures that are currently held by the institution have to be based on actual recovery data in order to produce a forward-looking estimate. The calculation should not be based solely on the market value of collateral; appropriate adjustments should be applied.

231. The calculation of default-weighted average of realised LGDs (Annex VII Part 4 Paragraph 73 of the [Directive 2006/48/EC](#)) requires the use of all observed defaults in the data sources. Observed defaults include incomplete work-out cases, although they will not have values for the final realisation of LGD because the recovery process has not ended.
232. Institutions should incorporate the results of incomplete workouts (as data/information) into their LGD estimates, unless they can demonstrate that the incomplete workouts are not relevant. The assessment of relevance should take into account market specifics and should show that the exclusion of incomplete workouts does not lead to underestimation of LGD and has no material impact on LGD estimations.
233. When institutions include incomplete work-outs in the calculation of the default-weighted average of realised LGDs, they should document and demonstrate the pertinence of their approaches, including, in particular, their choice of observation period and their methodologies for estimating additional costs and recoveries beyond this period and, if necessary, within this period.
234. The Workout LGD technique can be applied using either direct estimates or a two-step approach. When direct estimates are used, a quantitative estimate is derived for each individual exposure based on its specific characteristics. In a two-step approach, an average LGD is estimated for all exposures covered by the same facility grade or pool. If a pooling approach is used in the Retail exposure class, individual direct estimates must be averaged to produce an LGD for the pool, because it is necessary to produce an aggregated LGD for all exposures in a pool. However, the CRD proposal also allows Retail estimates to be derived using grades, in a similar way to those for Corporate, Institution, and Sovereign exposures. Where this method is used, there is no need to aggregate LGD estimates for Retail exposures.
235. A direct estimation procedure allows the automatic calculation of each of the discrete elements that make up LGD, based on the experience of each of the corresponding elements in an RDS which is relevant for the element in question (e.g., real estate recovery values, or discount rates). One example of a direct estimation procedure is a statistical model which uses risk drivers as explanatory variables. Under a two-step procedure, an overall adjustment to the LGD would instead be applied to the grade or pool as a whole, to reflect the extent to which the average LGD for the requisite RDS is not representative of the forward-looking long-run default-weighted average (or economic downturn estimate).
236. Market information may be used in a number of different ways in LGD estimation. Historical market prices realised on collateral or in

exchange for some or all of the claim on the obligor will inform estimates in the RDS when the Workout LGD technique is being used. Current market prices of collateral on current exposures will probably influence their estimated LGD. As an alternative to Workout LGD, the RDS may instead be derived from the observation of market prices on defaulted bonds or marketable loans soon after default or upon their emergence from bankruptcy. If an institution uses market information as an alternative to workout LGD (for example, in the case of scarce data), the market data should conform to the general requirements for the use of external data (see section 3.4.4. on data sources). An institution may derive the best estimate of expected loss for its defaulted exposures directly from their market prices where these exist. LGD estimates based on the market prices of defaulted obligations are known as Market LGDs. It is also possible to derive estimated LGDs from the market prices of non-defaulted loans or bonds or credit default instruments. These are referred to as Implied Market LGDs.

237. LGD estimates based on an institution's own loss and recovery experience should in principle be superior to other types of estimates, all other things being equal, as they are likely to be most representative of future outcomes. However, such estimates may be improved by the careful use of relevant external information such as market prices on defaulted exposures; this should be the case where internal data are scarce. It is challenging to derive a CRD-compliant LGD element from the credit spreads on performing exposures. Nevertheless, implied Market LGDs may be used where no other data are available to produce reliable estimates, and if validation results show that these estimates are reliable.
238. In practice, the market and implied market LGD techniques can currently be used only in limited circumstances. They may be suitable where capital markets are deep and liquid. It is unlikely that any use of market LGD can be made for the bulk of the loan portfolio.
239. The implied historical LGD technique is allowed only for the Retail exposure class. LGD estimates for Retail exposures may be derived from realised losses on exposures within the grade or pool and from appropriate estimates of PDs. The 'realised loss' for such Retail exposures is the total loss divided by the total number of exposures in the grade or pool, while the 'average realised LGD' is the same total loss divided by the number of defaulted exposures in the grade or pool. (See Annex VII, Part 4, Paragraphs 73, 74, and 82 of the [Directive 2006/48/EC](#)). The estimation of implied historical LGD is accepted in cases where institutions can estimate the expected loss for every facility rating grade or pool of exposures, but only if all the minimum requirements for estimation of PD are met. The estimation of PD should cover all the qualitative and quantitative requirements

of validation. The estimation of EL (in lieu of LGD) seems to bring additional challenges.

## **Downturn LGD**

239a. According to Annex VII, Part 4, Paragraphs 73 and 74 of the Directive 2006/48/EC, institutions shall estimate LGDs by facility grade or pool that are appropriate for an economic downturn where this would be more conservative than the long-run average. Producing such estimates presents challenges, given the limited data that institutions are likely to have available. Institutions should nevertheless establish a rigorous and well-documented process for assessing the effects, if any, of economic downturn conditions on recovery rates and for producing LGD estimates consistent with downturn conditions. The process will involve three tasks, which could be addressed in an integrated manner.

(1) Identifying appropriate downturn conditions for each supervisory exposure class within each jurisdiction.

Appropriate downturn conditions are those in which the relevant drivers of default rates are consistent with conditions in which credit losses for the supervisory exposure class are expected to be substantially higher than average. Institutions may identify such conditions at a more granular level if such an approach adds to risk sensitivity. However, as a general rule, where recovery rates are sensitive to local conditions, institutions should, at a minimum, consider each exposure class and each jurisdiction separately, unless they can justify the combination of exposure classes and/or jurisdictions on the grounds that exposures in the same exposure classes in different jurisdictions exhibit strong covariance in recovery rates. While institutions are building better data sets and developing more experience in estimating downturn LGDs, supervisors may choose to direct them to focus their efforts on types of exposures for which they believe the downturn effect is of special concern.

(2) Identifying adverse dependencies, if any, between default rates and recovery rates.

Adverse dependencies between default rates and recovery rates might be identified directly by statistical analysis, where data are available; or indirectly by examining the relationships between the drivers of default and recoveries. The indirect approach might include analysis of the behaviour of collateral values where collateral has a significant influence on recoveries.

(3) Incorporating any adverse dependencies that have been identified between default rates and recovery rates, in order to generate LGD parameters for the institution's exposures that are consistent with identified downturn conditions.

This might be achieved, for example, by analysing recovery rates during periods of economic downturn or by using forecasts based on the modification of appropriate risk drivers in a manner consistent with downturn conditions.

If no material adverse dependencies between default rates and recovery rates have been identified through analysis consistent with (2), the LGD estimates may be based on long-run default-weighted averages of observed loss rates or they may be derived from forecasts that do not involve stressing appropriate risk drivers.

- 239b. According to Annex VII, Part 4, Paragraph 74 of the Directive 2006/48/EC requires institutions to ensure that downturn LGDs used to calculate risk-weighted exposure amounts and expected loss amounts are not less conservative than the long-run average LGD. Institutions that cannot demonstrate in other ways that LGD estimates are not lower than their long-time average LGD estimates should be prepared to provide an estimate of the long-run default-weighted average loss rate given default to supervisors if requested. The downturn LGD may in some circumstances be the same as the long-run average LGD, but it may not be less conservative.
- 239c. Institutions are likely to calculate a variety of LGDs, conditional on different economic assumptions, for different reporting and management purposes. The rationale for using different LGDs and the specific reasons for the differences should, however, be explained and documented in accordance with the requirement of Annex VII, Part 4, Paragraph 55 of the Directive 2006/48/EC.
- 239d. There is no expectation that the stress tests referred to in Paragraph 41 or 42 of Annex VII, Part 4 of the Directive 2006/48/EC will necessarily produce an LGD that is either lower or higher than the LGD estimated according to Annex VII, Part 4, Paragraph 74. To the extent that the identification of downturn periods under Paragraph 74 coincides with the stress tests in Paragraph 41 or 42, the calculation might turn out to be similar. More generally, some stress test calculations under Paragraph 41 or 42 may function as one tool for assessing the robustness of the LGD estimation under paragraph 74.<sup>71</sup>

### **LGD for Expected Loss**

- 239e. Institutions that provide their own estimates of LGD should use LGD estimates appropriate for an economic downturn both in calculating risk weighted exposure amounts and in calculating expected loss for exposures that are not in default, if this is more conservative than

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<sup>71</sup> Paragraphs 41 and 42 of Annex VII, Part 4 of the CRD are being dealt with in the broader context of stress testing in the CEBS technical annex on this subject to the Guidelines on the Supervisory Review Process.

the long-run average. However, for defaulted exposures, the CRD requires the use of an estimate of expected loss ( $EL_{BE}$ ) that should be the best estimate of expected loss, given current economic circumstances. (See Annex VII, Part 1, Paragraphs 3, 10 (for retail exposures), and 29, and Part 4, Paragraph 79 of the Directive 2006/48/EC). In such cases, LGD is defined according to Paragraph 79 of Annex VII, Part 4 as the sum of  $EL_{BE}$  and a measure reflecting possible additional unexpected losses during the recovery period. If downturn conditions are relevant to a certain type of exposures, then this should be taken into account in measuring the possibility of additional unexpected losses during the work-out period. This treatment does not apply to exposures under the double default treatment, since, by definition, EL for these exposures is set at zero.

### 3.3.3.3. Conversion Factors

2. 240. The third parameter used in the supervisory formula for calculating regulatory capital requirements is Exposure Value. However, the CRD requires that the parameter to be estimated is the Conversion Factor (CF).
241. Article 87(9) of the [Directive 2006/48/EC](#) allows institutions to use own estimates of Conversion Factors. However, industry practice in this area is still at an early stage. In particular, the basic definitions and main principles that underlie the CF estimation process need to be clarified. A large proportion of this section is therefore devoted to definitions. It is envisaged that with time, as industry practice develops, more detailed guidelines on CF estimation and validation methodologies will be produced.

#### High level principles

242. CF estimates should reflect the experience and practices of the institution as well as the external environment in which it operates. CF, even more than PD and LGD, depends on how the relationship between institution and client evolves in adverse circumstances, when the client may decide to draw unused commitments. Careful consideration of these aspects should therefore be an integral part of the CF estimation and validation processes.
243. Any use that institutions might make of data gathered from external sources or across different time periods should be performed with care (see section 3.3.5. on external vendor models and section 3.4.4. on data sources).
244. Since a given percentage variation in exposure values results in an equal percentage change in capital charges, any approximation and/or shortcut in estimating exposure values that the institution

decides to adopt should form an important aspect of validation and assessment.

## Definitions

245. Although not explicitly stated, the CRD treats the exposure value as consisting of two positions: the amount currently drawn and an estimate of future drawdowns of committed but untapped credit. The potential future drawdowns are described in terms of the proportion of the undrawn amount.
246. The definition of Conversion Factor is given in Article 4(28), which states that 'conversion factor' means the ratio of the currently undrawn amount of a commitment that will be drawn and outstanding at default to the currently undrawn amount of the commitment. The definition can be analysed by examining its components:
- CFs shall be estimated for *current* commitments. Institutions are required to hold capital for commitments that they have currently taken on.
  - The CF shall be expressed as a percentage of the *undrawn* amount of the commitment.
247. Some institutions plan to use rating systems that estimate a ratio expressed as a percentage of the total commitment (total-limit ratio), rather than as a percentage of the undrawn amount of the commitment. Using a total-limit ratio is not compliant with the requirements of the CRD. Thus, the momentum approach (see Paragraph 253), in its simplest form, does not comply with the requirements of the CRD. However, institutions might apply to receive approval for CFs derived from the momentum approach if they take into account the measures highlighted below.
- The CF shall be *zero or higher*.
248. Even though it is not explicitly stated in the CRD, it is clear from the definition that CFs shall be zero or higher. This implies that the exposure value for any facility shall be no less than the exposure value as defined in Annex VII, Part 3, Paragraphs 1 to 10 of the Directive 2006/48/EC. If additional drawings after the time of default are not reflected in the LGD estimation, they have to be taken into account in the estimation of CF, whatever the method chosen.

### *Time horizon*

249. The above definition of Conversion Factor requires institutions to estimate how much of the *currently* undrawn amount will be drawn by the time of *default*. Calculating the Conversion Factor thus involves observing and comparing (at least) two points in time: the

present time and the time of default. Estimated Conversion Factors are derived from realised Conversion Factors for defaulted exposures in the RDS. The time of default and the drawn amount at default of the exposures in the RDS can be observed directly.

250. The following paragraphs provide a very brief outline of four different approaches to measuring realised CFs. This list is not meant to be exhaustive and does not preclude any other approach. Institutions are encouraged to develop approaches that best fit their specific business. In particular, the following descriptions do not relieve institutions of their responsibility to conduct their own analysis of which (if any) of the approaches described below best fits their business, or whether other approaches might be more appropriate. Similarly, they do not restrict the views of supervisory bodies concerning other methods, nor are they intended to hinder the development of more advanced methods of CF estimation.
251. Institutions should ensure that the points in time chosen for the calculation of realised CF in the RDS are appropriate for a one-year horizon for estimating CFs. This might require considering sets of different time intervals preceding the time of default.
- Cohort approach. The observation period is subdivided into time windows. For the purpose of realised CF calculations, the drawn amount at default is related to the drawn/undrawn amount at the beginning of the time window.
252. When using this approach, the institution shall use a cohort period of one year unless it can demonstrate that a different period would be more conservative and more appropriate.
- Fixed-horizon approach. The drawn amount at default is related to the drawn/undrawn amount at a fixed time prior to default. This approach implies the simplifying assumption that all exposures that will default during the chosen horizon will default at the same point in time: the end of the fixed horizon.
253. When using this approach, the institution shall use a fixed horizon of one year unless it can demonstrate that another period would be more conservative and more appropriate.
- Variable-horizon approach. This is a generalisation of the fixed time horizon. It consists of using several reference times within the chosen time horizon rather than one (for example, comparing the drawn amount at default with the drawn amounts at one month, two months, three months, etc. before default)
  - Momentum approach. Some institutions have traditionally expressed Conversion Factors in their internal systems as a percentage of the total outstanding limit (total-limit ratio), and not of the undrawn amount. Institutions that use this approach have no intrinsic need to decide on a reference point in time prior

to default, since the drawn amount at the time of default is compared only to the total limit at the time of default.

254. In its simplest form, the momentum approach does not fulfil the requirements of the CRD, because it estimates the total-limit ratio rather than the CRD-compliant conversion factor defined as a percentage of the undrawn amount. This has the consequence that the currently drawn amount is not considered. However, this method could be a starting point, if the institution addressed this weakness by recalculating the total-limit ratio as a CRD-compliant Conversion Factor using relevant information from the CF grade assignment process. The use of this method can only be a transitory solution, subject to reconsideration by the supervisory authorities.
255. At this stage, and until more detailed empirical evidence is gathered, supervisors are not ruling out any of the above approaches. Institutions are encouraged to develop more sophisticated rating and estimation systems for Conversion Factors. Regardless of the approach chosen, supervisors expect institutions to:
- Analyse and discuss their reasons for adopting a given approach, justify their choices, and assess the impact that the use of a different timeframe would have.
  - Identify the possible weaknesses of the chosen approach and propose methods to address or compensate for them.
  - Evaluate the impact of the chosen approach on final CF grades and estimates by investigating dynamic effects such as interactions with time-to-default and credit quality.
256. A sound approach to model development and an effective validation challenge should take these and other considerations into account. The documentation should provide clear information about these (and other) issues.

#### *Supervisory conversion factors versus own estimates*

257. Article 87(7) of the [Directive 2006/48/EC](#) requires institutions to provide own estimates of conversion factors for exposures belonging to exposure class (d) of Article 86(1), i.e. retail exposures. For exposures belonging to the exposure classes referred to in points (a) to (c) of Article 86(1), according to Article 87(8), institutions shall apply the conversion factors set out in Annex VII, Part 3, Paragraph 9 points (a) to (c) of the [Directive 2006/48/EC](#). The conversion factors for the instruments mentioned in Paragraph 9 have a fixed value (supervisory conversion factors).
258. However, according to Article 87(9), the competent authorities may permit institutions to use own estimates of conversion factors for the exposures mentioned above, in accordance with Article 84 and Annex

VII, Part 4, for the instruments listed in Annex VII, Part 3, Paragraph 9 of the [Directive 2006/48/EC](#).

259. The permission to use own estimates of conversion factors, if granted by the competent authority, will require the institution to apply its own estimates of conversion factors to all exposures indicated in Annex VII, Part 3, Paragraph 9 of the Directive 2006/48/EC (subject to the provisions on roll-out).
260. Annex VII, Part 3, Paragraph 11 of the Directive 2006/48/EC stipulates that: *For all other off-balance sheet items than mentioned in Paragraphs 1 to 9, the exposure value shall be the following percentage of its value: 100% if it is a full risk item, [...]. For these purposes the off-balance sheet items shall be assigned to risk categories as indicated in Annex II.*
261. Notwithstanding this provision, for the purpose of permitting the application of own estimates of conversion factors (as defined in Article 4(28)), supervisors will interpret 'credit line' (as indicated in Annex VII, Part 3, Paragraph 9 (c)) of the Directive 2006/48/EC as being sufficiently broad to cover each type of off-balance sheet exposure mentioned in Annex II that is not identified as a full-risk item and that is not already explicitly mentioned elsewhere in Annex VII, Part 3, Paragraph 9 (a) to (c). On an exceptional basis, institutions could use the supervisory Conversion Factors for some kinds of exposures, subject to the relevant supervisory authority's approval, if they can demonstrate that it's impossible to develop a relevant approach in order to estimate the CFs for those exposures. Full-risk items will remain subsumed under Paragraph 13 of Annex VII, Part 3 of the [Directive 2006/48/EC](#) and receive an exposure value of 100 percent of their value.

262.

### **Data**

263. The Reference Data Set for CF/Exposure Value should contain at least the following elements:
- As with the RDS for LGD, and unlike the RDS for PD estimation, only exposures to defaulting obligors should be included;
  - The drawn and undrawn amount at default;
  - The drawn and undrawn amount at a time (or times) prior to default; and
  - Factors must be available to group the defaulted facilities in meaningful ways.
264. Ideally, it should:
- Cover a period that is sufficiently long to include at least one business cycle;

- Contain all defaults that have occurred within the considered time frame;
  - Include all relevant information needed to estimate the risk parameters;
  - Include data on the relevant drivers of CF.
265. The institution should ensure that the RDS remains representative of its current portfolios. The RDS should therefore be updated when necessary (see Annex VII, Part 4, Paragraph 50 of the [Directive 2006/48/EC](#)).

## Risk Drivers

266. The CRD states that Conversion Factor estimates shall be based on material drivers of risk. Annex VII, Part 4, Paragraph 49 states some of the CRD's overall requirements for estimation.
267. Institutions need to consider and analyse all material risk drivers. Materiality should be judged on the basis of the specific characteristics of their portfolios and practices.
268. Industry practice has not yet developed in this area, and providing a minimum list of factors would be particularly difficult and controversial. However, some areas should be explored when investigating the potential drivers of the Conversion Factor parameter:
- The institution's strategies and policies with respect to account monitoring (Annex VII, Part 4, Paragraph 90 of the [Directive 2006/48/EC](#));
  - The institution's ability and willingness to prevent further drawings short of payment default (Paragraph 90);
  - Factors influencing the borrower's demand for funding/facilities;
  - Factors influencing the institution's willingness to supply funding/facilities;
  - The attitude of third parties (such as other financial institutions, trade creditors, and owners) whose presence as alternative sources of supply may increase or reduce the demand for funding/facilities for an individual institution; and
  - The nature of the particular facility and the features built into it (such as covenant protection).
269. This list should not be considered exhaustive, nor does the list prescribe how each specific driver should be used in the estimation approach. Institutions are encouraged to develop approaches which take account of a broader and more tailored set of drivers.

### 3.3.4. Quality of internal documentation

270. Annex VII, Part 4, Paragraphs 31 to 39 of the Directive 2006/48/EC set minimum requirements regarding documentation and data maintenance.
271. Supervisors should assess the institution's development, validation, and operation of rating systems used. As part of this process, a competent authority may itself replicate all or part of the institution's validation, or have a third party do so. The institution should document all its development and validation steps in such a way that a third party would be able to understand the reasoning and procedures underlying the development and validation. This also holds true for the documentation of the institution's operations.
272. At a minimum, the documentation of the development and validation of the institution's rating system should include detailed descriptions of the development methodologies, the assignment and classification processes, calibration, and the internal procedures, processes, and tests used by the institution to validate the rating system.
273. An institution should ensure that its rating systems are valid on an ongoing basis. Since rating systems and their operations are subject to constant improvements, validation should be an iterative process. After material changes in the rating system or processes, institutions should ensure that their documentation is up to date. The documentation of development and validation should record the iterations and the processes used to validate them.
274. The documentation should also reflect the fact that different rating systems can be used for different portfolios. Supervisors would expect institutions to maintain different sets of documentation on development, validation, and operations of each rating system or combination of rating systems used and of the portfolios to which they are applied.
275. All documentation relating to an institution's rating systems should be made available to the competent authority upon request, and to a third party acting as its agent.
276. Section 3.3.4. applies to all documentation regarding model development and validation, including rating systems and PD, LGD, and CF estimation.
277. The documentation of statistical models and other mechanical methods could cover at least the following areas:
1. Documentation of model design:
    - Delineation criteria for the rating segment.

- Description of the rating method, the type of model used, and the architecture of the model.
- Model architecture and fundamental assumptions, including the definitions of default, the rationale for and analysis supporting the choice of rating criteria, typical circumstances under which the model does not work effectively, and the general strength and weaknesses of the model.
- The reason for selecting a specific model type.
- Documentation of all model functions.
- Description of the rating process.
- Duties and responsibilities with regard to the rating model.
- Model change policy.

## 2. Documentation of development and analyses

- Relevance of the criteria used in the model.
- Dataset used in model development.
- Quality assurance for the dataset.
- Model development procedure.
- Selection of model input factors and assessment of model parameters.
- Quality assurance/validation during model development, including at least out-of-time and/or out-of-sample performance tests.
- In the case of models for estimating risk parameters, calibration of risk parameters per grade or pool
- Procedure for validation/regular review.
- Use of human judgement to complement the model.

278. Tests for quality assurance/validation should be performed only if the data needed to set aside for them do not unduly reduce the data set for model development. In cases of scarce data, it might be more advisable in some circumstances not to set aside an out-of-sample data set, but rather to wait until the following year and the respective new rating assignments, and use them as an out-of-time sample.

### 3.3.5. External vendor models

279. Annex VII, Part 4, Paragraph 35 of the [Directive 2006/48/EC](#) states that the use of a model obtained from a third-party vendor that claims proprietary technology is not a justification for exemption from documentation or any other of the requirements for rating systems. Thus these models generally have to fulfil the same requirements as models produced in-house.

280. In particular, Annex VII, Part 4, Paragraph 30 of the Directive 2006/48/EC requires institutions to prove that all models used

- (including external models) have good predictive power, that the data used to build the model is representative of the actual portfolio of the institution, and that a regular cycle of model validation is in place. The burden is on the institution to satisfy competent authorities that it complies with these requirements. In other words, supervisors will not validate external vendors.
281. Under the IRB approach, institutions can use statistical models in the rating process and/or to estimate the risk parameters required for the approach. Although it should be emphasised that the rating process in total should be an internal rating process, it is not necessary that all parts of the process be developed internally. Most institutions use externally developed statistical models to some extent in their rating process.
282. In the context of these guidelines, an external vendor model is a model or parts of a model used by an institution and developed by an independent external third party that uses certain inputs to assign exposures to certain rating grades or to estimate certain risk parameters.
283. In addition to the general requirements mentioned above, the transparency of the vendor model and of its linkage to the internal information used in the rating process will be examined closely by supervisors.

### **Transparency of the vendor model**

284. To fulfil the CRD's requirements regarding internal governance (Annex VII, Part 4, Paragraphs 124 to 127) and the requirements regarding the responsibilities of the Credit Risk control unit (Paragraphs 128 to 130) and the Internal Audit unit (Paragraph 131) for external vendor models, the institution has to prove that it understands the external model in all its aspects. The supervisor's assessment of the institution's use of external models will therefore place special emphasis on the in-house knowledge concerning the development and the appropriate use of external vendors' models.
285. This means, for example, that external vendors have to document the development and fundamentals of the validation process of their models in a way that permits third parties to gain a detailed understanding of the methodology applied and to assess whether the model is still performing adequately on their own customer bases. Moreover, the institution has to prove that the in-house knowledge to do this is available. In particular, institutions should be aware of all the limitations of the model and the circumstances in which the model does not perform as expected.
286. The institution has to ensure that users will be adequately trained in the use of the model, and that in-house instructors will be available. The institution also has to present plans for guaranteeing the

validation and, if necessary, further development of the model in the future. Institutions have to ensure that the performance of the model can be assessed, and adjusted if necessary, even in the event that the vendor discontinues support, or similar events.

### **Linkage to internal information used in the rating process**

287. The institution has to know what information (data) is processed in the external model and how this information is linked to information that is processed in-house: for example, if the vendor's definition of input factors such as sales and debt are consistent with those used in-house. The institution has to make sure that the aggregation of the different parts of the model does not result in an inconsistent rating method, particularly in cases where parts of the model developed externally are used simultaneously with parts developed in-house. It may also be necessary to check whether there is 'double counting' of information in the internal and external parts of the rating model. Finally, the combination of separately developed parts of a rating system requires an extra risk-quantification exercise: i.e., the risk parameters have to be estimated on an appropriate data set as in the case of a purely internally developed rating system.

An example:

288. Institution A estimates the rating class for corporate customers with a model that consists of two separately developed parts. Part A uses balance sheet data to estimate the probability of default with a statistical model purchased from an external vendor. Part B, using soft facts, was developed in-house, and also uses statistical methods.

289. The institution has to prove that the data used to build the external model is representative of the actual portfolio. If the model is used only for assigning exposures (i.e., for ranking borrowers in relative terms) the proof of consistency with the CRD's definition of default (Annex VII, Part 4, Paragraph 44) can be omitted.

290. If the institution also uses the model for PD estimation of rating classes (i.e., the PDs from model A are used as inputs in PD estimations for the entire model), the institution also has to prove that the default definition used in Part A is the same as the one used for Part B, and that both are consistent with the definition in the CRD. If this is not the case, the institution has to prove that it is able to map the default definition of Part A into Part B, and both definitions to the definition used in the CRD.

291. Furthermore, the institution has to be aware of how different information is processed in Part A. For validation purposes, the institution has to treat the combined outcome of the two parts of the model like the outcome of a single internally developed model. The institution should also compare the predictive power of the combined

model with the predictive powers of the individual parts. In this way, the institution could determine if one of the two parts is no longer predictive, or if the combination of the two parts is the cause for a decline in predictive power.

### **3.4. Data**

292. The CRD requires data to be held and stored for several different purposes.

293. Institutions' physical databases need not be built to address each of these purposes separately, but may contain data relating to a mix of purposes.

294. There may also be different sources of data:

- For creating the model for assignments: Internal, external, and pooled data might be used to determine the weight of the input variables.
- For calibrating the model for estimates: Internal, external, and pooled data (Annex VII, Part 4, Paragraphs 46, 66, 69, 71, 80 and 85 of the [Directive 2006/48/EC](#)) (external and pooled data with restrictions (Annex VII, Part 4, Paragraphs 57, 58, 64, 69, 111, 120, 129 and 130 of the Directive 2006/48/EC)).
- For outcome and performance data: Internal data generated during model development and use.
- For calculating the current minimum capital requirements: Internal data.

#### **3.4.1. Data accuracy, completeness and appropriateness**

295. Annex VII, Part 4, Paragraph 30 of the [Directive 2006/48/EC](#) requires the data used as inputs into the model to be accurate, complete, and appropriate. This refers to the use of a statistical model and other methods to assign exposures to obligors or facilities grades or pools. Within this context, these terms should be interpreted to have the following meaning:

296. 'Accurate' refers to the degree of confidence that can be placed in the data inputs. Data should be sufficiently accurate to avoid material distortion of the outcome.

297. 'Complete' means that databases provide comprehensive information for the institution (i.e., data for all relevant business lines and all relevant variables). While missing data for some fields or records may be inevitable, institutions should attempt to minimise their occurrence and aim to reduce them over time.

298. 'Appropriate' means that data do not contain biases which make them unfit-for-purpose.

## **IT systems for IRB calculation**

299. A sound IT infrastructure is essential for the integrity of the capital calculation. This soundness will be considered as part of a wider assessment by the supervisor. Databases that are used to replicate calculations need to be adequately archived and backed up. Institutions should document work-flows, procedures, and systems related to data collection and data storage.
300. Institutions should have IT systems that ensure:
- Continuous availability and maintenance of all relevant databases.
  - Replicability of databases and of the outputs of the rating systems for validation purposes.
301. These IT systems should be included in the institution's general contingency plans, in order to guarantee the recovery of the information. Established controls should prevent access by unauthorised people.
302. The information used in credit risk modelling is usually complex and extensive. Institutions should assign enough resources to allow for the possibility of expanding databases without the risk of losing information. Institutions should aim to reduce the risk of human error by increasing the automation of all material procedures used in the quantification of the capital requirement. However, sufficient IT support of IRB data should not be interpreted to mean that institutions have to store their complete data history 'online' and have all input data available at the push of a button, but rather that all data should be stored in a suitable way and should be ready to access within an appropriate time frame.

## **Audit review**

303. Reviews of data quality by Internal Audit or another comparable independent auditing unit should include at least the following: an annual review of controls, periodic sampling of data, and review of system reconciliations. For external data and pooled data, this work should be done to the fullest extent possible.

### **3.4.2. Data quality standards and consistency with accounting data**

304. Institutions should define their own standards for ensuring data quality and should strive to improve these standards over time. They should measure their performance against these standards. Institutions should work on an ongoing basis to ensure that their data is of high enough quality to support their risk management processes and the calculation of their capital requirements. This

- could include reviewing the structure of input data to identify outliers or implausible values, changes from previous periods, and the amount of missing data. The review should also indicate whether the integrity of data is being maintained.
305. Regular reconciliation against accounting data could provide an additional quality check. Institutions need to identify and explain material divergences that come to light in the reconciliation. Full reconciliation may not be possible, as risk data may differ from accounting data for good reasons (for example, 'Conversion Factor' has no equivalent in accounting), but should be performed when possible. In any case, institutions should perform consistency checks that include an audit trail of data sources, total and record count checks when data move between systems, recording of data that are excluded or introduced at different stages of data manipulation, etc. Significant discrepancies should be investigated.
306. Data should be subject to appropriate quality controls, according to their criticality. There should be minimum checks, including a periodic independent review to confirm that data are accurate, complete, and appropriate. For example, data quality could be reviewed by replicating the preparation of data (including collection and transformation) and the outputs of models, using the same databases and algorithms used by the institution. This could be done on a sample basis. Supervisors could assess specific parts of this process to verify the conclusions reached by the independent reviewer.
307. Institutions' rating assignment systems should include a well-justified policy on their tolerance for gaps in the data for an obligor and on conservative approaches to treating missing data, for example by substituting values. They should seek to minimise the amount of missing data over time.
308. In order to facilitate the dialogue between institutions and supervisors on data quality standards, institutions should provide their supervisors with an adequate set of documentation. The following can be regarded as good practice:
- Data policy and statement of responsibility: Institutions should establish an explicit data policy, which could be part of a general data policy. They are responsible for ensuring the quality of their data and should be able to convince supervisors that they meet fit-for-purpose standards.
  - Data directory: Institutions should have clear data directories (dictionaries) that provide definitions of data items.
  - Database descriptions: Documentation for databases should allow institutions to provide supervisors with the information needed to determine the soundness of the databases. For example:

- A general description of the databases (for example, information on the relational database model, including tables, keys, triggers, stored procedures; performance data such as overall maximal size; security information such as owner, users with read-and-write access, and maintenance responsibilities).
- The source of the data.
- The processes used to obtain and load the data.
- The filters used to create and debug the database (e.g., maximum and minimum values and treatment of missing values).
- Controls on access, consistency, etc.
- A specific description of the variables included.

309. Institutions should prepare a global map of all the data and IT systems weaknesses found during the internal review process (for example, lack of automation) with an assessment of their impact on the final calculation. Institutions should also state how they plan to correct the weaknesses.

### **3.4.3. Representativeness of data used for model development and validation**

310. The CRD's requirements for data samples used in the development of rating systems are different from those for samples used in estimating risk parameters (PD, LGD, and CF). The text refers variously to 'representativeness,' 'strong link,' and 'comparability,' depending on the purpose for which the data are used (assigning exposures to obligors or facilities, grades or pools, risk parameter estimation) and on the data sources (external, internal, pooled data). In certain cases, the CRD requires 'broad equivalence' between the definitions of default and loss used in the data sets and the supervisory definition given in Annex VII, Part 4, Paragraphs 44 and 45.

### **Data requirements**

311. In fulfilling the requirements on data quality, any uncertainties – if they are admissible at all – should be accompanied by some degree of greater conservatism in the estimates or in the assignment processes, as required in Annex VII, Part 4, Paragraphs 19 and 54 of the [Directive 2006/48/EC](#). However, institutions should not treat the application of conservatism as a substitute for fully meeting the requirements. Where conservatism is applied, it should be based on the institution's internal practices. Data requirements for the observation period (Annex VII, Part 4, Paragraphs 66, 71, 86, and 95 and the possible relaxation mentioned in Article 154 of the Directive

2006/48/EC) should be satisfied fully, without the option of compensating shorter observation periods with applied conservatism.

### **Data sets used for risk parameter estimation (comparability)**

312. Institutions have to demonstrate the comparability of data sets used for estimation to the institution's current portfolio (Annex VII, Part 4, Paragraph 52 of the Directive 2006/48/EC). This applies equally to internal, external, and pooled data and to the combination of such data sources. The interpretation of 'comparability' should include at least the following points:

- Comparability should be based on analyses of the relevant characteristics, e.g. the population of exposures represented in the data used for estimation, the lending standards used when the data was generated, and other relevant characteristics, in comparison to the corresponding properties of the institution's current portfolio. Other relevant characteristics could include, for example, the distribution of the obligors across industries, the size distribution of the exposures, and similarity in the geographic distribution of the exposures, to the extent that these apply to the respective data sets.
- In analysing the comparability of populations, key characteristics (quantitative and qualitative obligor and facility characteristics) that could relate to default (for PD estimation) or loss (for LGD estimation) should be taken into account. The analysis should be based on these characteristics or on a mapping from one set of characteristics to the other. For example, the analysis could consider the distribution of the population according to the key characteristics and the level and range of these key characteristics. In all cases, and especially for external and cross-border samples, any differences in the meaning of the key characteristics should be documented and considered in the model-building or risk quantification. It is expected that the distribution of the population and the level and range of these key characteristics should approximate those of the corresponding institution's current portfolio. Although it is unrealistic to expect a perfect match in every case, the institution should nevertheless ensure that the distributions are reasonably close.
- Material observed differences in the key characteristics used for estimation are relevant information in the sense of Annex VII, Part 4, Paragraph 49 of the [Directive 2006/48/EC](#), and should be taken into account in estimations by making appropriate adjustments. If adjustments are difficult to quantify, the institution should consider the use of other data sets.
- Statistical tools may be used to quantify and ensure the evidence.

## Data used for developing models for exposure assignment or risk parameter estimation (representativeness)

313. The representativeness requirement of Annex VII, Part 4, Paragraph 30(c) of the Directive 2006/48/EC applies both to models and other mechanical methods used to assign exposures to grades or pools, and to statistical default prediction models generating default-probability estimates for individual obligors (see Annex VII, Part 4, Paragraph 65 of the [Directive 2006/48/EC](#)). The interpretation of 'representative' includes the following points (the first, third, and fourth points are also valid for the estimation of risk parameters):

- Representativeness in the sense of Paragraph 30(c) of the Directive 2006/48/EC should be interpreted similarly, regardless of the source of the data: internal, external, or pooled data sets, or a combination of these.
- Representativeness for the assignment of obligors does not require that the proportion of defaulted and non-defaulted exposures in the data set be equal to the proportion of defaulted and non-defaulted exposures in the institution's respective portfolio.
- For analysing the representativeness of the sample with respect to the population of the institution, all key characteristics (quantitative and qualitative obligor and facility characteristics) that could relate to default (for PD estimation), loss (for LGD estimation), or additional drawings (for CF estimation) should be taken into account. The analysis should be based on these characteristics or on a mapping from one set of characteristics to the other. For instance, the analysis could include considering the distribution of the population according to the key characteristics and the level and range of these key characteristics. Material observed differences in the key characteristics should be avoided, for example by using another sample.
- Where applicable, the use of statistical methodologies (such as cluster analysis or related techniques) to demonstrate representativeness should be recommended.
- The CRD does not contain requirements on the definitions of default and loss used in building the model for assignments of obligors or exposures to grades or pools. Institutions are allowed to use their own definitions provided they document them and apply them consistently, and as long as the CRD's requirement for good predictive power (Annex VII, Part 4, Paragraph 30(a)) is fulfilled.

### Pooled data sets

314. Annex VII, Part 4, Paragraph 57(b) of the [Directive 2006/48/EC](#) requires that "the pool shall be representative for the portfolio for which the pooled data is used." The interpretation of 'representative' in the context of data pools includes the following points:

- Representativeness should be demonstrated according to plausible criteria that have been set in advance in a general policy.
- These criteria could include the comparability of populations of exposures in the relevant parts of the pool.
- In the case of pooled data, the default definition used by an institution for any part of the pool should be similar to the default definition used for that part by the other institutions in the pool. Any underestimation of risk that might result from applying similar default definitions should be avoided. Institutions should particularly avoid curtailing their use of 'unlikelihood to pay' indicators in order to achieve this similarity in default definitions.
- Where applicable, the use of appropriate statistical methods to demonstrate representativeness should be recommended.

### **Use of data histories**

315. Annex VII, Part 4, Paragraph 50 of the Directive 2006/48/EC requires institutions to demonstrate that their estimates of the risk parameters are representative of long-run experience. Representativeness, in the context of Paragraph 50, means that the estimates based a future time horizon of one year nevertheless reflect at least the relevant events experienced by the institution in the past over a longer time period.

#### **3.4.4. Data sources and definition of default**

316. If institutions use external data sets for risk parameter estimation, they should apply appropriate adjustments to their estimates in order to achieve broad equivalence to the reference definition in the CRD. In the case of pooled data, the definition of default used by the institution for any part of the pool/data set should be similar to the default definition used for that part by the other institutions in the pool, as required by Annex VII, Part 4, Paragraph 57(a) of the Directive 2006/48/EC.
317. Special considerations for default definitions of pooled data sets: for data sets collected from the same market, the similarity of the definition of default could be checked by examining the wording of the definition and the internal use of the definition, or by looking at the practical usage of the definition for that market.
318. For cross border-data sets, the broad scope of the CRD's definition of default could result in country-specific definitions. Two cases should be distinguished here (see also section 3.3.2.1. on the definition of default):

- Due to the strong link of the CRD's definition of default to accounting and bankruptcy laws, the same wording of the definition of default could have different meanings or be interpreted differently across jurisdictions. An example of this is the meaning of 'non-accrued status.'
  - An institution might identify additional indicators of unlikelihood to pay that are typical for a given country. In this case, the definitions of default will not have the same wording, but the meaning of default could be the same.
319. In either case, the institution should demonstrate that the definitions of default used by the institutions that participate in the pool are similar.

### **3.5. Quantitative and qualitative validation and its assessment**

#### **3.5.1. High level principles on validation**

320. CEBS endorses the definition of validation and the six general principles for validation described in the Basel Committee's Newsletter of January 2005 (["Update on the work of the Accord Implementation Group related to validation under the Basel II Framework"](#)). In this section, CEBS provides additional guidance on validation. This additional guidance is shown in italics in order to distinguish it from the rest of this section, which is drawn directly from the general principles in the Basel newsletter.
321. One of the greatest challenges posed by the revised capital framework, for both institutions and supervisors, is validating the systems used to generate the parameters that serve as inputs to the internal ratings-based (IRB) approach to credit risk. The IRB framework requires institutions to assess the ability of a borrower to perform in adverse economic conditions. Thus, when considering the appropriateness of any rating system as the basis for determining capital, there will always be a need to ensure objectivity, accuracy, stability, and an appropriate level of conservatism.
322. Internal ratings and default and loss estimates must play an essential role in the credit approval, risk management, internal capital allocation, and corporate governance functions of institutions using the IRB approach. The CRD recognises that the management of institutions continues to bear responsibility for validating the inputs to the IRB approach. Supervisors have the responsibility for assessing the compliance of institutions' validation of their rating systems and inputs with the IRB framework's minimum standards. Supervisors must ensure that these requirements are met, both as qualifying criteria and on a continuing basis. Validation is thus a fundamental aspect of the IRB approach.

## What is meant by 'validation'?

323. In the context of rating systems, the term 'validation' encompasses a range of processes and activities that contribute to an assessment of whether ratings adequately differentiate risk and whether estimates of risk components (such as PD, LGD, or CF) appropriately characterise the relevant aspects of risk. *Rating systems and their outputs are typically used by credit institutions for a range of different purposes. As a general rule – and without prejudice to the more general requirements of the use test, which requires institutions to justify differences between measures used for regulatory risk parameters and internal purposes – validation by institutions needs to take into account the specific purpose or purposes for which a rating system is being used, including whether appropriate amendments have been made for each purpose. Supervisors will pay special attention to the validation of IRB systems for regulatory capital purposes.*

324. There are several general principles that underlie the concept of validation. They can be summarised as follows:

### **Principle 1: Validation is fundamentally about assessing the predictive ability of an institution's risk estimates and the use of ratings in credit processes**

325. An institution's IRB estimates are intended to be predictive. While grounded in historical experience, they should also be forward-looking. Rating systems should effectively discriminate risk (i.e., credits with lower ratings should have a higher risk of loss) and calibrate risk (i.e., they should accurately quantify the risk of loss). Rating systems should also be consistent. If the processes that are used in assigning risk estimates are not accurate, then the risk estimates may fail to be sufficiently predictive and may under- or over-state required regulatory capital. Consequently, validation should focus on assessing the forward-looking accuracy of the institution's risk estimates, the processes for assigning those estimates, and the oversight and control procedures that are in place to ensure that the forward-looking accuracy of these estimates is preserved going forward. As a general rule, the validation process should prompt a reassessment of the IRB parameters when actual outcomes diverge materially from expected results.

- In order to ensure the predictive accuracy of its risk estimates as well as the effective discrimination and calibration of risk, an institution will first need to assess the general appropriateness of each of its rating systems.

This assessment will cover at least:

- Verification that each rating system is characterised by an appropriate balance of objectivity, accuracy, stability and conservatism.
  - Objectivity requires the adoption of policies and standards that ensure that ratings and estimates are applied consistently to borrowers and facilities with similar characteristics and posing similar levels of risk. Judgement is a necessary part of any overall rating system. It plays an important role in the development of the system and in the assignment of individual ratings and estimates, including overrides. However, institutions must be able to verify how the use of judgement is managed in order to achieve consistent outcomes. (For the purposes of comparing outcomes against expected performance, institutions should be able to identify how their estimates have been adjusted from the most likely outcome.)
  - Accuracy requires the adoption of policies and standards relating to the expected performance of the rating system (outcomes versus predictions) and to the integrity of inputs into the rating system and their conversion into outputs.
  - Stability requires the adoption of policies and standards that ensure that ratings and estimates are broadly unchanged when the underlying risk has not changed. This should not preclude changes that are intrinsic to the rating philosophy of the system.
  - Conservatism requires the adoption of policies and standards that identify the sources and range of uncertainty in ratings and estimates, and the degree of conservatism. In particular, the policies should identify where and explain how the institution applies conservatism in accordance with the relevant requirements of the CRD.
- The appropriateness of the philosophy of each rating system
  - The philosophy of a rating system can be characterised by two components: the philosophy underlying the grade or pool assignment (i.e.,: how institutions assign exposures, obligors or facilities to 'risk buckets' (according to appropriate risk drivers) and the method used to quantify the risk parameters associated with each grade or pool.
  - The CRD does not prescribe the philosophy that must underlie the grade or pool assignment in a rating system.

Each philosophy results in a specific dynamics of ratings. The philosophy underlying the grade or pool assignment could be characterised by the extent to which a change in economic conditions is expected to result in a net migration of a large number of exposures, borrowers, or facilities to other grades or pools (if the institution were to take no compensating policy actions), as opposed to migration of some exposures, borrowers, or facilities to other grades or pools due only to their individual characteristics while leaving the number of exposures, borrowers or facilities in each grades or pools substantially unchanged, or a hybrid between these two extremes.

326. In order to assess the appropriateness of the philosophy of a rating system, the institution should:
- Understand the philosophy underlying the grade or pool assignment, and specifically the risk drivers, and whether they create homogeneous buckets with respect to the targeted estimator. (An example for the PD dimension is whether the buckets are homogeneous with respect to the likelihood that each obligor in each risk bucket will default over the next year given all currently-available information, including obligor and economic information; or, alternatively, with respect to the likelihood that each obligor in each risk bucket will default over the next year given all available information and hypothetical stress-scenario economic conditions.)
  - Assess whether the method used to quantify the risk parameter is adequate for the philosophy underlying the grade or pool assignment.
  - Understand the characteristics, including the dynamics, of its ratings and of its risk parameter estimates.
  - Assess the adequacy of the resulting characteristics, including the dynamics, of the ratings and risk parameter estimates with regard to their different uses.
  - Understand the impact of the characteristics, including the dynamics, of the ratings and risk parameters estimates on the dynamics and volatility of capital requirements.
327. For example, the institution should at least adopt and document policies which explain the philosophy of each rating system and how grades and risk parameters are expected to vary with movements in the general economic cycle or more specific cycles relevant to each risk parameter. These should include descriptions of how, if at all, rating assignments and risk parameter estimates are impacted by the application of conservatism.

328. When an institution uses different rating systems characterised by different philosophies, care should be taken in the use of information, either for rating assignments or estimates, from another (internal or external) rating system that has a different rating philosophy. An example is the use of rating information or default experience obtained from rating agencies.
- When an institution uses different rating systems with different characteristics (for example, different philosophies, levels of objectivity, accuracy, stability, or conservatism) it should ensure that they have an appropriate level of consistency and/or that the differences between them are well understood. This understanding should at least enable the institution to define an appropriate way to combine/aggregate the information produced by the different rating systems when this is necessary. The assumptions and potential inaccuracies arising from such a combination/aggregation should be fully understood.
329. For example, the institution should at least describe how the combination of information from rating systems characterised by different philosophies impacts the dynamics and volatility of capital requirements.
- 329a. Historical data are an important source of information for constructing estimates of future default frequencies and losses, but they are only a starting point and should be adjusted with care. The minimum data periods (five or seven years) determine how much (minimum) historical experience is needed as an input to the forward-looking estimates, and are not meant to imply that an average of actual experience is a sufficient measure for the forward-looking estimates. Nevertheless, where an institution can demonstrate that the historical experience is likely to be an accurate estimate of the forward-looking estimate, little or no adjustment may be needed.
- 329b. Forward-looking estimates can be lower than actual historical experience. This may be because of small sample size, because the historical experience contains a disproportionate number of extremely bad years, or because practices have changed. However, a high burden of proof would be placed on any institution that sought to ignore or significantly underweight some of the available data.
- 329c. PD estimates must be based on the long-run average of default rates in each grade or pool. This implies that the historical experience needs to include a representative mix of good and bad years for the economy as a whole, as well as addressing more specific (e.g., industry) cycles that are material to the level and volatility of defaults in exposures covered by the rating system. Institutions must demonstrate that the estimates they are using are representative of likely long-run rates. Where (internal or external) statistical

prediction models are used, this may require an adjustment to the calibration of those models.

329d. Similar considerations apply to estimates of LGD and CF based on default-weighted averages. These averages will naturally be oriented towards the losses expected to be incurred (or the appropriate CF) under conditions when defaults for the exposures in question are expected to be high, as opposed to more normal market conditions. This should encourage more stable estimates, although institutions should ensure that those estimates are at least conservative enough to represent economic downturn conditions, if this is more conservative than the long-run average.

329e. Institutions should have policies and standards covering the levels of accuracy (and, where relevant, discriminative power), the acceptable levels of divergence from the expected performance, and the action to be taken when these acceptable levels are breached. They should also have clear policies for the circumstances in which these standards may be changed.

### **Principle 2: The credit institution has primary responsibility for validation**

330. Supervisors do not have the primary responsibility for validating credit institutions' rating systems. Rather, a credit institution has the primary role, and consequently must validate its own rating systems to demonstrate how it arrived at its risk estimates and confirm that its processes for assigning risk estimates are likely to work as intended and continue to perform as expected. Supervisors, on the other hand, should assess the credit institution's validation processes and outcomes and may rely upon additional processes of its own design, or even those of third parties, in order to have the required level of supervisory comfort or assurance.

### **Principle 3: Validation is an iterative process**

331. Validation is likely to be an ongoing, iterative process in which institutions and supervisors periodically refine validation tools in response to changing market and operating conditions. Institutions and supervisors will need to engage in an iterative dialogue on the strengths and weaknesses of particular rating systems.

- *Institutions will need to adjust and improve their validation techniques in response to changing practices in the industry and as more data becomes available.*

### **Principle 4: There is no single validation method**

332. While some validation tools (e.g., backtesting, benchmarking, replication, etc.) may prove especially useful, there is no universal quantitative or qualitative tool that can be used for all portfolios in all

institutions. Backtesting, for example, may prove difficult for portfolios where there is a low level of historical defaults. Validation techniques may converge over time, but in practice there will likely be differences in validation techniques across portfolios (e.g., retail vs. wholesale credit) and across markets. In addition, the underlying philosophy of the rating system must be well-understood and properly taken into account when determining which validation tools and techniques should be applied. This applies both to the choice of validation methods for assessing the accuracy and stability of a rating system, and to the choice of methods for assessing the appropriateness of the stress tests applied to that system.

- *A validation process needs to contain a mix of developmental evidence (assessing the logic of the approach, its conceptual soundness, statistical testing performed prior to use), benchmarking and process verification (comparisons to relevant alternatives, verification that the process is being applied as intended), and outcomes analysis (backtesting).*
- *The balance in the required use of these tools will vary between rating systems, depending for example on the extent to which outcomes analysis is reliable.*

**Principle 5: Validation should encompass both quantitative and qualitative elements**

333. While validation can be thought of as a purely technical/mathematical exercise in which outcomes are compared to estimates using statistical techniques – and such technical tools may indeed play a critical role in such assessments in some circumstances – focussing solely on comparisons between predictions and outcomes is likely to be insufficient. In assessing the overall performance of a rating system, it is also important to assess the components of the rating system (data, models, etc.) as well as the structures and processes underlying the rating system. This should include an assessment of controls (including independence), documentation, internal use, and other relevant qualitative factors.

- Outcomes analysis is not a sufficient technique for validating all or part of a rating system. To the extent that outcomes analysis does provide strong support for the estimates, there will be less need to rely on other elements. However, even in these cases, institutions should focus on the possibility of future changes in the economic environment, borrower composition, the institution's practices, etc., which result in those estimates no longer proving valid in the future. Where outcomes analysis is less reliable, more emphasis will need to be placed on how the rating system is implemented and used in practice, the reasonableness of other validation procedures used and how

they are monitored, and the existence of an appropriate control and technology environment.

- Institutions should be able to bring sufficient experience and judgement to the development, adjustment, interpretation, and validation of rating systems and estimates, to supplement purely quantitative techniques.
- The qualitative phase of the institution's assessment should focus on how the various information is interpreted to produce final assignments of the grades or pools and parameter estimates.

### **Principle 6: Validation processes and outcomes should be subject to independent review**

334. It is important that a credit institution's validation processes and results should be reviewed for integrity by parties within its organisation that are independent of those responsible for the design and implementation of the validation process. This independent review may be accomplished using a variety of structural forms. The activities of the review process may be distributed across multiple units or housed within one unit, depending on the management and oversight framework of the institutions. Regardless of the credit institution's control structure, Internal Audit has an oversight responsibility to ensure that validation processes are implemented as designed (see also Paragraph 389).

#### **3.5.2. Validation tools: Backtesting and Benchmarking**

335. Annex VII, Part 4, Paragraphs 110 to 114 of the [Directive 2006/48/EC](#) require the institution's estimation to be accurate and consistent (Paragraph 110), regular back-testing and benchmarking of their IRB risk quantification for each grade (Paragraphs 111 and 112), ensuring the consistency of methods and data through time and documenting changes in methods and data (Paragraph 113), and taking account of unexpected changes in economic conditions (Paragraph 114). The following part of these guidelines elaborates on these requirements and fleshes out general principles 4 and 5 discussed above.

336. Institutions are expected to provide sound, robust, and accurate predictive and forward-looking estimates of risk parameters (PD, LGD and CF). They shall have a system of risk segmentation which accurately differentiates risk, and a quantification process which accurately estimates those parameters. The institution's validation process has to ensure that these requirements are met on an ongoing basis.

337. Common quantitative validation tools include backtesting and benchmarking of the internal rating system outputs. The CRD

explicitly requires institutions to use both tools in their validation process (Annex VII, Part 4, Paragraphs 111 and 112). Backtesting consists of checking the performance of the risk rating systems estimates by comparing realised risk parameters with estimated risk parameters. Benchmarking consists of comparing the outputs of the reviewed risk rating systems with relevant external data sources provided that those data are appropriate to the portfolio (according to Annex VII, Part 4, Paragraph 112 of the [Directive 2006/48/EC](#)). In cases where a lack of internal or external data prevents the proper use of these techniques, institutions should apply an appropriate margin of conservatism in their estimations. However, if the lack of data is caused by the efforts of the institution to use only data that was collected under economic downturn conditions, the use of an additional layer of conservatism should be carefully assessed.

### **Backtesting against internal data ratings system**

338. Backtesting generally involves comparing realised (ex-post) values with estimated (ex-ante) parameters for a comparable and homogeneous data set (for example, comparing realised default frequencies with estimated PDs). The following guidance focuses on backtesting estimates of risk parameters in each grading grade against their realised values.
339. Backtesting is expected to compare realised default rates, loss severities, and exposure-at-default experience in each rating grade with the PD, LGD, and CF values that have been estimated using an internal IRB model. This can be accomplished by using statistical methods to implement statistical tests for defining acceptable levels of the potential discrepancy between ex-ante expectations and ex-post realisations.
340. At a minimum, the assessment of backtesting results should focus on the following issues:
  - The underlying rating philosophy used in developing rating systems – see Paragraph 325 (e.g., are PDs derived from point-in-time or through-the-cycle ratings?). Institutions that use different rating systems will need to take into account any differences in their rating philosophies when backtesting estimates of risk parameters. Failing to do so would lead to erroneously assigning differences in rating philosophies to inaccuracies in reported estimates;
  - Institutions should have a policy that outlines remedial actions, for example, whenever back testing results breach internal tolerance thresholds for validation, if such thresholds are used;
  - When backtesting is hindered by lack of data or insufficient quantitative information, institutions will need to rely more heavily on additional qualitative elements such as quality control

tests, benchmarking with external information, etc. This might be particularly relevant in the case of estimates that relate to rarely observed economic downturn conditions (see Paragraph 325);

- The identification of the specific reasons for discrepancies between predicted values and observed outcomes (e.g., variations through time that might affect institutions' risk analysis and consequently their backtesting results);
- At a minimum, institutions should adopt and document policies which explain the objectives and logic underlying their backtesting exercises.

### **Benchmarking the outputs of internal ratings systems against external data**

341. Benchmarking involves assessing the consistency of the estimated parameters with those obtained by other estimation techniques (such as other rating systems), and potentially using other data sources (such as other institutions or ECAs). It helps to assess whether institutions have quantified the risk parameters accurately by comparing them with a set of 'reference data' consisting of alternative PD, LGD and CF estimates from internal and external sources.
342. When performing benchmarking risk estimates against other sources, institutions are expected to investigate the sources of substantial discrepancies between the values of risk parameters resulting from their internal risk rating system and those obtained from the other sources.
343. Regardless of the benchmarking method used, institutions shall demonstrate to supervisors that their rating systems are performing in compliance with the minimum requirements in Annex VII, Part 4 of the [Directive 2006/48/EC](#).
344. At a minimum, the assessment of benchmarking results should focus on the five points listed in paragraph 340 of this paper. Specifically, institutions should consider:
  - The underlying rating philosophy used in developing rating systems (e.g., are PDs derived from point-in-time or through-the-cycle ratings?). Institutions that use different rating systems will need to take into account any differences in their rating philosophies when benchmarking estimates of risk parameters. Failing to do so would lead to erroneously assigning differences in rating philosophies to inaccuracies in reported estimates;

- The procedure for establishing tolerance thresholds for validation, and the list (at least in broad terms) of the types of possible responses when thresholds are breached;
- The additional qualitative elements of their implementation of benchmarking;
- The identification of unanticipated changes over time that might affect benchmarking results;
- At a minimum, institutions should adopt and document policies which explain the objectives and logic underlying their benchmarking exercises.

### 3.5.3. Low-default portfolios

345. The CRD applies certain conditions to PD estimations (for example, the institution must estimate long-run, forward-looking expected default rates for each rating grade, with an appropriate margin of conservatism). Certain conditions also apply to their validation. Some institutions have raised concerns that they may not be permitted to apply IRB approaches to portfolios with a low number of defaults due to the lack of sufficient default or loss data to satisfy the CRD requirements for validation.
346. Low-default portfolios are portfolios with few or no defaults observed. Low-default portfolios can arise under different circumstances, and can be categorised as follows:
- Long-term, due to high-quality borrowers (e.g., institutions) or a small number of borrowers (e.g., sovereigns), versus short-term (e.g., new entrants into a market); or
  - Systemic (data unavailable for all institutions), versus institution-specific (data unavailable for the institution in question, perhaps due to insufficient effort to enhance its database with suitable external data).
347. The following principles are aimed at systemic low-default portfolios, and do not generally apply to institution-specific low-default portfolios.
348. Exposures in low-default portfolios should not necessarily be excluded from the IRB approach simply because of the absence of sufficient data to validate PD, LGD and CF estimates on a statistical basis. Such exposures may be included if institutions can demonstrate that the methods and techniques applied to estimate and validate PD, LGD and CF constitute a sound and effective risk-management process and are employed in a consistent way. Institutions will be required to use appropriate conservatism in risk parameter estimation.

349. The institution's process for estimating PD, LGD, and CF in low-default portfolios should be supported by appropriate methodologies. Even in the absence of defaults, additional information (ratings, prices, etc.) might be available that can be used in the estimation process. Wherever possible, institutions should take such additional information into account in their estimation process. The validation process for low-default portfolios should not be completely different from the validation process for non-low-default portfolios, and institutions should ensure compliance with the minimum requirements laid down in applicable regulations, in particular regarding adequate margins of conservatism.
350. Institutions should pay particular attention to implementation and use, and to ensuring that control and technology environments and internal validation procedures are appropriate.
351. Institutions should reinforce qualitative validation of low-default portfolios, relative to non-low-default portfolios. The design of rating models, the quality of the data used in developing and deploying the model, and the internal use of the rating system should be key areas of the validation process for low-default portfolios. A high level of compliance with the use test is an important indicator of an institution's confidence in its estimates, and will therefore be viewed as a necessary part of meeting the minimum requirements. However, meeting the use test is not in itself a sufficient condition, and should in any event be treated with particular caution for low-default portfolios, given the inherent difficulty in proving the accuracy of the estimates of PD, LGD, and CF. As is the case with non-low-default portfolios, standardised procedures should be applied for assigning ratings in low-default portfolios. These procedures can be based on expert judgement and/or on external data. In any case, it is necessary to monitor the quality, objectivity and credibility of the data sources, and to strengthen the transparency and completeness of documentation.

**Quantitative Validation:**

352. Limitations in the dataset should not exempt institutions from performing a quantitative validation on low-default portfolios. Whenever few or no defaults are observed, a quantitative validation could be approximated (e.g. by assessing rating migrations, using credit spreads where appropriate etc.). Adequate and consistent methods should be used to ensure a sound and effective assessment and measurement of risk. The criteria to be reviewed in quantitative validation should include at least calibration, discriminative power, and stability.
353. The approach for calibration is likely to be based more on expert judgement, utilising the extensive internal and/or external experience with the particular type of business.

354. Institutions could use a variety of quantitative and qualitative analyses to provide confidence in, and an indication of, the discriminative power of the models. Depending on the amount of data, different techniques can be used:
- Internal benchmarking.
  - Comparison with other ratings and models.
  - Comparison with other external information.

### **3.6. Internal governance**

355. Annex VII, Part 4, Paragraphs 124 to 127 of the [Directive 2006/48/EC](#) set out minimum requirements regarding corporate governance and oversight, including a brief description of the roles of the management body and senior management. This section of the guidelines elaborates further on those minimum requirements.
356. Paragraphs 362 to 364 provide an example of the general approach applied in this section. The aim is not to lay down a 'one-size-fits-all' approach to assessing an institution's organisational structure, internal governance, and internal control systems. Supervisors should tailor their assessment to the characteristics of respective institutions, taking into account their size and the complexity and nature of their business ('proportionality principle'). This could include a 'comply or explain' approach, in which an institution that has come to a different solution from the one set out by the supervisors has the opportunity to explain why it has chosen that solution and to convince the supervisors that it is at least as good as the solution suggested by the supervisors .
- 357.. Annex VII, Part 4, Paragraphs 124 to 126 of the [Directive 2006/48/EC](#) place requirements on the 'management body' and 'senior management' for understanding and approving rating systems. 'Management body' is defined in Article 11 of the Directive 2006/48/EC, and should be understood to embrace different structures, such as unitary and dual board structures. In keeping with CEBS Guidelines on Application of the Supervisory Review Process under Pillar 2, the use of these terms does not advocate any particular board structure. The management body represents the top management level of an institution, and senior management (which is not defined in the CRD) should be understood to represent the level of management below the management body.
358. According to the CEBS Guidelines on the Supervisory Review Process, there are two key functions that must be fulfilled in any institution: supervision and management. Most Member States use one of two corporate governance structures: a unitary or a dual board structure. In a unitary board structure, one body (e.g. the 'board of directors') performs both the supervisory and management

- functions. In a dual board structure, the two functions are performed by different bodies. When the CEBS Guidelines on the Supervisory Review Process identifies a function of the management body, it specifies whether the reference is to the supervisory function, the management function, or both.
359. For the purpose of the present guidelines, it is not appropriate for CEBS to seek to define the responsibilities of the supervisory and management functions of the management body, because of the high degree of granularity in the CRD with regard to the IRB (and AMA – see section 4.3.5.) approaches, and the different traditions and legal frameworks. Therefore, it is up to each national authority to define which function of the management body is responsible for the tasks and responsibilities listed in the internal governance sections below, and which internal body of the institution represents the supervisory and which the management function.
  360. Annex VII, Part 4, Paragraph 128 of the [Directive 2006/48/EC](#) refers to the 'Credit Risk Control Unit' (CRCU). It is useful at this point to distinguish between the organisational part and the functional part (the Credit Risk Control function) of this term. As part of the internal control function, the Credit Risk Control function should be independent from the business lines it monitors and controls. It is designed and implemented to address the risks that the institution identifies through the risk assessment process.
  361. Large and complex institutions should establish a risk control unit to monitor each of the material risks (within material business lines) to which the institution is exposed. The risk control unit should report to senior management and other relevant staff.
  362. Although in most cases the organisational part of the CRCU and the CRC function would be identical (and consequently the CRCU would encompass only people responsible for fulfilling the Credit Risk Control function), the CRCU could, as an organisational unit, encompass both the people responsible for the design of the model and the people responsible for the independent review of the model.
  363. As far as the design of the rating models is concerned, the CRD affirms that the CRCU "shall be responsible for the design or selection, implementation, oversight and performance of the rating systems" (Annex VII, Part 4, Paragraph 128). It thus appears that the two broad functions of model review and model development and selection could be performed by the same unit. A rationale for this structure could be found in the skills and experience of the people who design or select models, which sometimes make them the only ones able to review and validate models. Furthermore, the separation of the two units could be burdensome, especially in smaller institutions.

364. The coexistence of both functions in the same unit should not be seen as an obstacle; any potential for lack of objectivity should be offset with controls, administered by the Internal audit or another comparable independent audit unit, to prevent bias from affecting the rating process.

### **3.6.1. Role of the management body and senior management**

#### **Hierarchy of responsibility, management body and senior management**

365. Sound internal governance requires that the decision-making process be clearly stated within each institution, in terms of hierarchy and level of responsibility. In order to improve understanding of the rating system among the members of the management body, and to improve efficiency, the management body may, where appropriate, establish specific Risk Committees and delegate certain aspects of this framework to these committees or to senior management. Senior management itself may also delegate certain tasks. However, such delegations do neither relieve the management body and senior management from their obligation to have a general awareness of the IRB framework used by their institution, nor do they relieve the management body from its ultimate responsibility for the IRB framework and senior management from its responsibility for developing and implementing it.
366. In accordance with Annex VII, Part 4, Paragraph 124 of the [Directive 2006/48/EC](#), all material aspects of the rating and estimation processes shall be approved by the institution's management body (or a designated committee thereof) and senior management. These parties shall possess a general understanding of the institution's rating systems and detailed comprehension of its associated management reports. The material aspects of the rating and estimation processes include among others:
- Risk management strategies and policies regarding the internal rating system (including all material aspects of the rating assignment and risk parameter estimation processes);
  - The organisational structure of the control functions;
  - Specifying acceptable risk (using IRB results to define the credit risk profile of the institution).
367. Both the management body and senior management are responsible for making formal decisions on the implementation of the IRB approach. This includes the overall approval of the project, the specification of goals, and the appointment of the organisational structures responsible for implementation. A schedule of the necessary steps should be provided with the project approval. Both functions are ultimately responsible for sound governance of the IRB framework, and the further governance described below should flow from them.

368. The management body has to exercise effective oversight. Therefore, as stated in Paragraph 125 of Annex VII, Part IV of the CRD, senior management shall notify the management body, or a designated committee thereof, of material changes or exceptions from established policies that will materially impact the operations of the institution's rating systems. The management body should be involved, on an ongoing basis, in the oversight of the control procedures of Internal Audit.
369. Senior management should ensure, on an ongoing basis, that the control mechanisms and measurement systems adopted by the credit risk control unit are adequate and that the overall IRB system remains effective over time. Senior management shall have a good understanding of the rating systems designs and operations. Furthermore, it should have a good understanding of credit policies, underwriting standards, lending practices, and collection and recovery practices, and should understand how these factors affect the estimation of relevant risk parameters. It should ensure that the following tasks are being addressed:
- Ensuring the soundness of risk-taking processes, even in a rapidly changing environment;
  - Determining how internal ratings are used in the risk-taking processes;
  - Identifying and assessing the main risk drivers, based on the information provided by the Credit Risk Control Unit;
  - Defining the tasks of the risk control unit and evaluating the adequacy of its professional skills;
  - Monitoring and managing all sources of potential conflicts of interest;
  - Establishing effective communication channels in order to ensure that all staff are aware of relevant policies and procedures;
  - Defining the minimum content of reporting to the management body or to bodies to which it has delegated responsibilities (e.g., the Risk Committee), and
  - Examining reports from Internal Audit or another comparable independent audit unit.
370. Senior management should also check, on a regular basis, that the control procedures and measurement systems adopted by the credit risk control unit and Internal Audit (or another comparable independent audit unit) are adequate and that the overall IRB system remains effective over time.
- 370a. The credit risk control unit is responsible for proper functioning of the rating systems; it submits rating systems for approval.

370b. The Internal Audit or another comparable independent auditing unit should provide an assessment of the overall adequacy of the internal control system and of the credit risk control function.

### **Internal reporting**

371. Internal ratings-based analysis of the institution's credit risk profile should be an essential part of the internal reporting system. The recipients of the reporting should include not only the management body and senior management, but also all of the internal functions responsible for originating and monitoring credit risks. The frequency and content of reporting should be formally approved by both the management body and senior management.

372. The frequency and scope of reporting should be set according to the nature of the recipient and the level of risk. The level of risk could depend, for example, on the ratings or the size of exposures

372a. Reporting to senior management should enable it to monitor the evolution of credit risk in the overall portfolio. The scope of information (e.g., rating classes, PD bands) to be included in the internal reporting may vary according to the nature, size, and degree of complexity of the business and the institution.

373. The minimum requirements of the [Directive 2006/48/EC](#) relating to reporting are specified in Annex VII, Part 4, Paragraph 127. Good practice in satisfying these requirements could include providing the following information:

- A description of the rated portfolios (amounts, number of obligors, PDs per grade, percentage of coverage with ratings with respect to the total portfolio, breakdown by entities, sectors, sub-portfolios, and business units);
- The distribution of the overall portfolio according to rating grades, PD bands, and LGD grades, and a comparison with the previous year;
- A comparison of realised default rates (and loss given default and credit Conversion Factors for institutions on advanced approaches) against expectations;
- The results of stress tests;
- An estimate of regulatory capital requirements and economic capital; and
- The portfolio's migration across rating grades.

374.

375. In addition to the reporting mentioned above, the Credit Risk Control Unit should address specific reports to senior management relating to the rating system review process. It is the responsibility of the

CRCU to provide coherent reporting that is clearly related to target variables.

### **3.6.2. Independent Credit Risk Control Unit**

#### **Goal/Scope of activity**

376. The main goal of the Credit Risk Control Unit (Annex VII, Part IV, Paragraphs 128 to 130 of the [Directive 2006/48/EC](#)) is to ensure, on a regular basis, that the rating system and all of its components – rating assignments, parameter estimation, data collection, and oversight – are functioning as intended. The Credit Risk Control Unit should perform the following tasks, among others:

- Design of the rating system (perform or review);
- Ongoing review of the rating criteria and model development;
- Verification of the accuracy of all risk-rating grades;
- Assessment of consistency across industries, portfolios, and geographical regions;
- Assessment of model use;
- Analysis of the reasons for overrides and exceptions;
- Quantification process (perform or review);
- Backtesting;
- Analysis of actual and predicted ratings transitions; and
- Benchmarking against third-party data sources.

377. The results of the CRCU's review should be reported to senior management at least twice annually.

#### **Proportionality**

378. Establishing a specific unit responsible for developing and designing the rating system, and a separate unit that contains only the CRC function, could be burdensome, especially for smaller and less sophisticated institutions. Implementing the minimum requirements of the CRD could, in practice, impose some redundancies from an organisational point of view (e.g., a Credit Risk Control Unit composed of only a handful of officers).

379. In these cases, national supervisors can decide to make specific adjustments to these guidelines, taking into account the nature, size, and level of complexity of the business performed by the institutions applying for the use of the IRB approach.

380. However, such adjustments should not undermine the principle of independence of the CRC function or the overall soundness of the control environment. For example, in some small institutions, the Credit Risk Control function is also responsible for the rating

assignment process for specific obligors. This may be due to staff scarcity, or because staff in the CRC function who are directly involved in model building and review are more skilled in the assignment of ratings, especially to counterparties whose creditworthiness is difficult to assess (e.g., Specialised Lending, large and complex groups).

381. In this case, a lack of objectivity may arise because the model builder may have an excessive degree of confidence in the model output, and may become more tolerant towards potential failures or biases. Therefore, depending on the circumstances, the coexistence of the two tasks may be regarded either as an exceptional (permanent) or a transitional solution, in the latter case to be overcome as soon as possible. The coexistence should be made transparent in any case.

### **Location of CRC function within the organisational structure**

382. Any attempt to specify where in the organisational structure of an institution the CRC function should be located could be to some extent counterproductive, for the following reasons:
- The activities of the CRC function span multiple areas or business units.
  - Institutions will choose a structure that fits their management and oversight frameworks.
383. A minimum requirement, however, could be to make the CRC function depend directly on senior management, wherever the unit is located within the organisation. Part of the duties of Internal Audit should be to review whether the location of the CRC function could reduce its independence.
384. The CRC function should always have high standing within the organisation, and should be staffed by individuals possessing the requisite stature, skills, and experience.

### **Independence of the CRC function from the functions responsible for originating or renewing exposures**

385. Lack of independence of the Credit Risk Control function and pressures from relationship managers could seriously undermine the effectiveness and soundness of the IRB system. The problem is how to ensure and enforce independence. A control function can generally be regarded as independent if the following conditions are met:
- The staff of the control function should not have any tasks to perform that fall within the scope of the activities that the control function is assigned to monitor and control.

- The control function should be organisationally separate from the activities it is assigned to monitor and control. The head of the control function should be subordinated to a person who has no responsibility for managing the activities that are being monitored and controlled (in this case these activities would be originating and renewing exposures).
  - The head of the control function should report directly to both the management body and senior management and/or the audit committee.
  - The remuneration of the control function staff should not be linked to the performance of the activities that the control function is assigned to monitor and control.
386. There is no single way to achieve independence, but rather different options. One option is to make the CRCU depend directly on senior management. Another option could be to maintain a separation between the control functions and the commercial area/relationship managers, up to the level of the responsible member of senior management.
387. Whatever option is adopted by the institution, part of the duties of Internal Audit should be to determine the 'real' degree of independence of the CRC function.
388. A strict separation between the commercial function and the CRC unit (but not the CRC function) could have undesirable effects. For example, models developed by risk managers without the contribution of relationship managers could be rejected by the latter, or staff from the commercial lines could be tempted to force some of the model's inputs (especially qualitative inputs) in order to 'adjust' the model's outcome to their assessments (affecting the use test). Consequently, staff from the credit risk control unit and commercial department should cooperate actively in the development of the model. In order to ensure the desired independence after model development is complete, the exchange of information could best be through committees.

### **3.6.3. Role of Internal Audit**

389. The Internal Audit function reviews whether the institution's control systems for internal ratings and related parameters are robust (Annex VII, Part 4, Paragraph 131 of the [Directive 2006/48/EC](#)). It should therefore have an appropriate understanding of all the processes of the rating systems, including those processes which generate the estimates of risk parameters. As part of its review of control mechanisms, Internal Audit will evaluate the depth, scope, and quality of the Credit Risk Control function's work. Internal Audit may also conduct tests to ensure that Credit Risk Control function's

- conclusions are well-founded. Internal Audit should also review the adequacy of the IT infrastructure and data maintenance. For institutions using statistical models, Internal Audit should conduct tests (for example, on specific business units) in order to check data input processes.
390. Internal Audit or another comparable independent audit unit should report at least annually to both the management body and senior management on the institution's compliance with the IRB requirements.
  391. In order to strengthen its independence, Internal Audit should not be directly involved in model design/selection. Although not directly related to independence (but rather to credibility), Internal Audit units should always have a high standing within the organisation and should be staffed by individuals possessing the requisite stature, skills, and experience.
  392. Notwithstanding the need for independence, some cooperation between Internal Audit and the CRC function can be desirable, for example in order to address potential weaknesses or biases in the rating system. For instance, information on overrides detected by the CRC function in a specific portfolio or business unit should be passed on to Internal Audit so that it can assess whether the overrides stem from model biases (for example, because the model is unfit to produce ratings for specific businesses) or from a lack of independence of relationship managers. Nevertheless, it should be clear that the CRC function has sole responsibility for the rating systems' performance. The audit function should not be involved in day-to-day operations such as reviewing each individual rating assignment.

#### **3.6.4. Independence/conflict of interests in rating assignment**

393. Independence in the rating assignment process depends on how an institution is organised and on how it conducts its lending activities. Although rating processes may vary by institution or portfolio, they generally involve an 'assignor' and an 'approver,' whose tasks and responsibilities could differ. (Their tasks and responsibilities may vary also by portfolio.) Some of the most common situations are:

##### Rating assignment made by relationship managers

394. Some institutions have adopted 'judgemental approaches' for assigning ratings to counterparties. Such approaches entail some responsibilities for relationship managers, who are called upon to assess the creditworthiness of the obligors based on qualitative questionnaires or specific templates.
395. As relationship managers are primarily responsible for marketing the institution's products and services, and their compensation is usually

tied to the volume of business they generate, giving them responsibilities for assigning and approving ratings would give rise to an inherent conflict of interest. Credit quality and the ability to produce accurate risk ratings are generally not major factors in a relationship manager's compensation. Relationship managers may also become too close to the borrower to maintain their objectivity and remain unbiased.

396. For non-retail business institutions should not delegate rating responsibility (assignment or review) entirely to relationship managers. Relationship managers should only play a partial role in the rating assignment process, carrying out preliminary credit assessment to be validated afterwards by other 'independent' officers (see paragraphs 402 and 403 of this paper, on "Rating assignment based on mixed approach"). In this case, institutions should offset the potential lack of independence with controls to prevent the bias from affecting the rating process. Such controls should operate in practice and would include, at a minimum, a comprehensive, independent review of ratings by risk control functions (for example, off-site monitoring by the credit controllers, analysis of rating performances by the CRCU, and on-site review by Internal Audit or another comparable independent audit unit). An additional way to enforce the independence of the rating assignment is to link the compensation of the relationship manager to risk-adjusted performance measures (such as RAROC) based on the outputs of the IRB system.

#### Rating assignment by models whose outcome cannot be modified by the users.

397. This solution is typically adopted for retail and consumer banking, where the large number of loans, in small amounts make it essential to minimise the cost of rating assignment. In this case, the assessment of creditworthiness is basically made by the model itself.
398. Biases in model-based rating assignments could stem only from errors or fraud in the input of relevant data. Consequently, independent vetting of input data becomes crucial. The CRC function should verify on an ongoing basis that the model remains predictive of risk, by means of specific validation sessions based, for example, on backtesting or benchmarking of model outcomes.

#### Rating assignment by independent credit officers/rating committees

399. Some institutions assign sole responsibility for assigning and approving ratings to credit officers or rating committees that report to an independent credit function. This solution is aimed at separating the people who 'own' the relationship and propose new credit applications from the people who are ultimately responsible for the rating assignment. In addition to assigning and approving ratings, credit officers regularly monitor the condition of obligors and refresh ratings as necessary.

400. In this approach, the relationship between relationship managers and credit officers, and the organisational structure of the institution, become crucial, essentially because the 'true' degree of independence of the credit officer/rating committee could be difficult to evaluate in practice, especially for the largest counterparties for which approval limits are set at the level of senior management or the management body. Another potential disadvantage of this structure is that credit officers may have limited access to borrower information. This could affect the discriminative and predictive power of ratings.
401. The role played by the CRC function therefore becomes crucial, especially with regard to the assessment of ratings' performance and the ongoing review of the rating system.

#### Rating assignment based on mixed approach

402. A mixed approach is sometimes used for exposures to Corporates or SMEs. The following example is illustrative. The rating assignment is initially determined by statistical or judgemental models. If the relationship manager, who is responsible for data input, is satisfied with the model's outcome, then the final rating will be the model's rating. If, on the other hand, the relationship manager disagrees with the model's outcome, he can propose an 'override' to a senior officer – or to a rating committee, according to the size of the exposure – which is ultimately responsible for confirming the model's rating or changing it. For smaller clients (such as SMEs in retail portfolios), relationship managers are sometimes free to change the model's rating within certain limits (they typically can upgrade only by a few notches, while they are free to downgrade as much as they want).
403. When a mixed approach is used, the features of the models combined with the organisational structure of the institution become crucial. For example, if the rating model is not suited to a particular class of obligors or facilities, there will probably be a large number of overrides, and relationship managers may also be tempted to 'cheat' the model. Institutions should therefore ensure that all relevant information is considered in the rating assignment process, and should take the necessary steps to identify potential rating errors. In addition, controls are needed to ensure accuracy of data inputs. Finally, all 'management overrides' should be duly motivated by the relationship managers and all relevant decisions (both confirmations and rejections of proposed overrides) should be stored, in order to allow the CRC function to perform backtesting correctly.

### **3.6.5. Reliance on the work of external auditors in the review process**

- 404. *The CRD contains several references to tasks that should be performed by an independent assessment unit. For example, Annex X, Part 3, Paragraph 6 states that “the operational risk management processes and measurement systems shall be subject to regular reviews performed by internal and/or external auditors.” These reviews could be performed either by the institution’s internal unit or by an external auditor. As the external auditor may also be involved in performing the institution’s statutory audit, the question of independence arises.***
405. Supervisors will seek to understand the scope of an external audit review, and specifically whether particular subsidiaries are excluded from the review, perhaps on grounds of materiality. The purpose of this requirement is to ensure that the results of the external audit review are not incorrectly taken to apply to the subsidiaries.
406. The management of an institution (subsidiary or otherwise) is responsible for, and has full, independent control over the review of the institution, regardless of whether that review is performed by an internal or external unit. The management of the institution should communicate directly with the assessment unit at all stages, and the assessment unit in turn should report directly to the management of the institution during the review.
407. The external auditor may perform an independent assessment of a vendor’s technology only if there are no relationships (including commercial and/or marketing relationships) between any parts of the two companies that could compromise the independence of the assessment.
408. An institution using a vendor’s methodology should also perform a review through its own Internal Audit or other internal assessment unit, to ensure a thorough understanding of the vendor’s methodologies. Such a review should be considered reliable only if it is performed by a unit (internal or external) that is sufficiently familiar with all aspects of the reviewed systems and methodologies.

## **4. Supervisor’s assessment of the application concerning the minimum requirements of the CRD – Operational risk**

### **4.1. Partial use combinations**

409. The CRD allows a broad range of partial use possibilities, including the combined use of the Basic Indicator Approach (BIA) and the Standardised Approach (TSA) (Annex X, Part 4, Section 2), and the use of the Advanced Measurement Approach (AMA) in combination

- with other approaches (Annex X, Part 4, Section 1). The question arises of how the different approaches can be aggregated to calculate the regulatory capital requirement.
410. The CRD text does not distinguish between group (consolidated) and legal-entity (solo) calculations, creating a need for coherent interpretation. Moreover, the CRD does not explicitly either allow or prohibit the practice - specifically recognised in Paragraphs 682 and 683 of the Basel II text – of allowing institutions to include (on a permanent basis) the results of the AMA calculation of a subsidiary in the consolidated capital requirement of a parent company that otherwise uses a non-advanced approach.
411. The following definitions are provided for clarification:
- ‘Partial use at consolidated level’ means that different operational risk approaches are used simultaneously by the parent and its subsidiary, or by different subsidiaries/business lines within the group.
  - ‘Partial use at solo level’ means that different operational risk approaches are used simultaneously for different business lines or different branches within the same legal entity.
412. The issue in ‘partial use at consolidated level’ is not whether a subsidiary/business line of a banking group is allowed to use a certain calculation method at its own level, but rather whether the parent undertaking is allowed to use the results of that subsidiary/business line in determining its overall consolidated operational risk capital requirement.
413. Similarly, the issue in ‘partial use at solo level’ is not whether an institution is allowed to use a certain calculation method at the business line or branch level (for instance, for internal information purposes or in preparation for a future move to a more sophisticated approach), but rather whether the institution is allowed to use the results of that business line or branch calculation in determining its overall solo operational risk capital requirement.
414. Since the Alternative Standardised Approach (ASA) is a variant of the TSA, the possibilities for combining TSA with BIA or AMA offered in Annex X, Part 4 of the [Directive 2006/48/EC](#) are also available for combining ASA with BIA or AMA.
415. An institution using the BIA, TSA, or ASA for its consolidated capital requirement calculation may be allowed to include the result of an AMA calculation at a subsidiary in its consolidated calculation.
416. An institution using the TSA or ASA for its consolidated capital requirement calculation is allowed to include the result of a BIA

calculation at a subsidiary in its consolidated calculations. This combination possibility can be used in the case of recent business acquisitions and in other exceptional circumstances.

417. Art 105 (4) of the Directive 2006/48/EC, states that, where a credit institution and its subsidiaries use an AMA at consolidated level, the competent authorities may allow the qualifying criteria set out in Annex X, Part 3 to be met by the parent and its subsidiaries considered together. The subsidiaries/BLs which does not meet the qualifying criteria (not even together with the parent) should calculate their solo capital requirement according to one of the simpler approaches. This amount should also be the contribution to the AMA consolidated capital requirement (building block method)

417a. Where a credit institution uses an AMA at solo level, the competent authorities may allow the qualifying criteria set out in Annex X, Part 3 to be met by the main office and its business lines/branches considered together. Where a credit institution uses a TSA or ASA at consolidated (solo) level, the competent authorities may allow the qualifying criteria set out in Annex X, Part 2 to be met by the parent and its subsidiaries/business lines (main office and its business lines/branches) considered together.

418. The tables below provide an overview of the different partial use combinations on a group-wide and legal-entity basis, indicating how consolidated and solo capital requirements should be computed.

**Table 1**

**GROUP WIDE basis: Partial use combinations and “Consolidated capital requirement”**

|                                                       | Group level approach       |                                             |                                    |
|-------------------------------------------------------|----------------------------|---------------------------------------------|------------------------------------|
| <b>1.1.1 Subsidiary /Business line level approach</b> | <i>Group uses BIA</i>      | <i>Group uses TSA (or ASA)<sup>72</sup></i> | <i>Group uses AMA<sup>73</sup></i> |
| Subsidiary locally uses BIA                           | -                          | Partial use acceptable                      | Partial use acceptable             |
| Subsidiary/business line locally uses TSA (or ASA)    | Partial use not acceptable | -                                           | Partial use acceptable             |

<sup>72</sup> See also Annex X, Part 4 Paragraph 4 of the Directive 2006/48/EC ([http://eur-lex.europa.eu/LexUriServ/site/en/oj/2006/l\\_177/l\\_17720060630en00010200.pdf](http://eur-lex.europa.eu/LexUriServ/site/en/oj/2006/l_177/l_17720060630en00010200.pdf)).

<sup>73</sup> See also Annex X, Part 4 Paragraph 2 of the Directive 2006/48/EC and paragraph 429 of these guidelines.



## 4.2. The simpler approaches (BIA/TSA/ASA)

### 4.2.1. Entry criteria and use of TSA and ASA

419. The CRD offers several approaches for calculating regulatory capital requirements for Operational risk:
- The Basic Indicator Approach (BIA) (Article 103);
  - The Standardised Approach (TSA) (Article 104);
  - The Alternative Standardised Approach (ASA) (Article 104(3) and Annex X, Part 2, Paragraphs 9 and 13); and
  - The Advanced Measurement Approach (AMA) (Article 105 and Annex X, Part 3).
420. An institution wishing to use the ASA has to meet the qualifying criteria for the TSA (Annex X, Part 2, Paragraph 12 of the [Directive 2006/48/EC](#)) as well as the specific conditions imposed for the ASA (Annex X, Part 2, Paragraphs 10 and 11).
421. An institution wishing to use the TSA has to inform its competent authorities in advance of its intentions. They will make clear how this ex-ante information can be provided (informally or by way of a formal notification). The institution has to hold supporting documentation related to the observance of the TSA qualifying criteria. It has to deliver a document certifying, based on a self assessment, that it meets the TSA qualifying criteria. The certification document based on a self assessment may not be required if the competent authorities perform their own assessment to determine whether the institution complies with the criteria set out in the CRD for the use of the TSA. The choice of how this process is organised (on-site versus off-site) is at the convenience of the competent authorities.
422. An institution wishing to use the ASA has to inform its competent authorities of its intentions in advance and also has to receive a prior ex-ante authorization from its competent authorities according to Article 104(3). It has to inform its competent authorities of its intention. They will make clear how this ex-ante information can be provided (informally or by way of a formal notification). The institution has to hold supporting documentation related to the observance of the TSA qualifying criteria and the ASA conditions. It has to deliver a document certifying, based on a self assessment, that it meets these criteria and conditions. The certification document based on a self assessment may not be required if the competent authorities perform their own assessment. The choice of how this process is organised (on-site versus off-site) is at the convenience of the competent authorities.

#### **4.2.2. General and specific conditions for the use of ASA**

423. Annex X, Part 2, Paragraph 10 of the [Directive 2006/48/EC](#) sets a quantitative condition on the relative size of retail and commercial banking activities for institutions opting for the ASA. In particular, the retail and/or commercial banking activities shall account for at least 90 percent of the institution's income. In addition, Paragraph 16 requires that the institution must be able to demonstrate to the authorities that a significant proportion of its retail and/or commercial banking activities consists of loans associated with a high probability of default.
424. In order to provide institutions some stability in the choice of the ASA, a certain degree of flexibility can be introduced in the practical application of the 90 percent condition. In particular, a one-year window can be granted, meaning that even if the three-year average drops below 90 percent, an institution using the ASA can be allowed to remain on the ASA if it can convince the relevant authority that the three year average will again reach 90 percent the following year.
425. Institutions opting for the ASA are required to use robust and well-documented demonstration methods, relating to both the charging of high interest rate margins and the holding of a risky credit portfolio. National supervisors may allow non-IRB institutions opting for the ASA to use non-PD-based approaches to demonstrate that a credit portfolio is risky.

#### **4.2.3. Relevant indicator: three-year average**

426. The calculation of the capital charge for operational risk under the BIA, TSA, or ASA in accordance with to Annex X, Part 1, Paragraph 2 and Part 2, Paragraph 1 of the [Directive 2006/48/EC](#) is based on the three-year average of the relevant indicator. The three-year average, while designed to reduce the volatility of the capital charge, may, in exceptional circumstances, such as recent acquisitions or disposals of entities or activities, lead to an over- or under-estimation of operational risk.
427. If an institution can satisfy its competent authority that – due to exceptional circumstances such as a major sale – using a three-year average to calculating the relevant indicator would lead to a major overestimation of its current operational risk under Pillar I, the competent authority can allow the institutions to use a different calculation.

### 4.3. AMA

#### 4.3.1. Roll-out

428. The roll-out issues for operational risk (Annex X, Part 4 of the [Directive 2006/48/EC](#)) are significantly different from those for credit risk. Annex X, Part 4, Section 1 sets out the roll-out conditions for institutions that apply the most advanced technique (AMA), and Annex X, Part 4, Section 2 sets out the conditions for institutions that apply the less sophisticated approaches (BIA/TSA/ASA). When applying for permission to use the AMA, institutions should be expected to fulfil not only the main requirements of the Directive 2006/48/EC (Annex X, Part 4, Paragraph 1), but also two additional conditions (of Annex X, Part 4, Paragraph 2), which are discretions for the national supervisory authorities:
- a) On the date of implementation of an AMA, a significant part of the institution's operational risks has to be captured by the AMA; and
  - b) The institution makes a commitment to roll-out the AMA across a material part of its operations within a time schedule agreed with its competent authorities.
429. Supervisory authorities are expected to apply these discretionary conditions in most cases. There could be cases where these additional conditions might not be imposed, but these should be exceptional. Once the two discretionary conditions are imposed, the significance of the operational risks captured by AMA and the materiality of the part of the operations captured by AMA will need to be assessed. The methods used to conduct this assessment can be quantitative, qualitative, or a combination of the two. Regardless of the methods used by competent authorities, all operations should be captured by one of the operational risk methodologies.
430. The roll-out policy should address at least two different issues: the time horizon and the roll-out sequence.
- The roll-out plan should have a definite time horizon. It should be short enough in order to avoid prolonging AMA applications unduly, and long enough to ensure the quality of governance, data, methodology, and output.
  - The sequence in which operations are included in the AMA can be chosen by the institution, if agreed by the supervisor, starting, for example, with the riskier of the remaining operations.
431. Once a decision to grant AMA approval to a firm is taken, no further formal Article 129 process will be required as a result of roll-out of the AMA. During the roll-out period, however, supervisors will

cooperate in the spirit of Article 129 [of Directive 2006/48/EC](#). As the AMA is rolled out, supervisors may want to satisfy themselves that the minimum standards of the CRD are being met with respect to the additional operations or additional operational risks covered by AMA roll-out. To facilitate this process, institutions should complete a self-assessment against the minimum standards prior to rolling out the AMA to additional operations or additional risks. Supervisors will have three options, and will specify in the decision document which option or mixture of options is being used. Conditions may need to be attached to the decision in order to give effect to the option or options selected. The three options are:

1. Relying on normal supervisory activity to verify that minimum standards are met. Although formal prior notification requirements will not be introduced, other than the roll-out plan, institutions will be expected to keep supervisors informed of plans and developments in their risk measurement and management practices. Although an ex-ante assessment by supervisors will not be a formal requirement, supervisors may nevertheless choose to undertake an assessment of the operational risk measurement system in the period before the institution starts to use it for regulatory capital purposes.
  2. Asking institutions to notify supervisors on a timely basis of their intention to roll-out the AMA to additional operations or additional operational risks. As with (1), although an ex-ante assessment by supervisors will not be a formal requirement, supervisors may nevertheless choose to undertake an assessment of the operational risk measurement system in the period before the institution starts to use it for regulatory capital purposes.
  3. Asking institutions to notify supervisors on a timely basis of their intention to roll out the AMA to additional operations or additional operational risks, and perhaps requiring institutions to receive explicit permission before extending the use of the AMA. In this case, a prior assessment by supervisors may be required before permission is granted.
432. Institutions should have systems and procedures that monitor in a timely and appropriate manner the consistency of the partial use combinations and the significance, materiality, and time-frame issues of the roll-out plan.
433. Institutions should notify their competent supervisors in a timely fashion of any relevant changes in the organisational or business environment, due to either normal or exceptional circumstances (for example, a major acquisition or disposal or a major change in shareholders, management, or organisation), that could significantly impact on the institutions' initial partial-use or roll-out plans. The institutions should discuss with their supervisor or supervisors any changes to the roll-out plan that may be needed.

434. A merger or an acquisition is considered an important event that is likely to call for modifying the institution's partial use and roll-out policies. Two situations can be distinguished: first, where an AMA institution acquires a non-AMA institution, and second, where a non-AMA institution acquires an AMA institution. In the first case, the AMA institution may be asked to submit a new Article 129 application with a new partial use and roll-out policy for the supervisor's analysis, or it may be asked to submit a plan for bringing the entire institution into compliance with the CRD. The second case is more difficult, since the acquiring institution does not have AMA permission and some requirements, such as senior management understanding, may not be met. The institution would normally be asked to make a new Article 129 application.

#### **4.3.2. Use test**

435. Annex X, Part 3, Paragraph 2 of the [Directive 2006/48/EC](#) requires the institution's internal operational risk measurement system to be closely integrated into its day-to-day risk management process ('use test'). The use test for the AMA is not elaborated in the CRD to the same extent as the use test for the IRB approach.

436. The operational risk measurement system of an institution must have certain key elements. These elements must include the use of internal data, external data, scenario analysis, and factors reflecting the business environment and internal control systems (Annex X, Part 3, Paragraph 9 of the Directive 2006/48/EC).

437. The following section establishes a framework of four broad principles which industry would have to consider, at a minimum, in order to satisfy the use test. For each principle, typical examples of actions that could be undertaken are also provided. The examples illustrate ways to comply with the principles, and are not meant to be either binding or exhaustive.

#### **Principles and examples**

##### **1. The purpose and use of the AMA should not be limited to regulatory purposes.**

Evidence of meeting the use test could include, but is not limited to:

- *Providing evidence that the risk measurement system is used to manage operational risk exposures across different business lines within the organisation structure.*
- *Providing evidence of how inputs, estimations, predictions, or outputs from the risk measurement system are used in the decision-*

*making process, for example as an element in strategic and tactical decision-making.*

**2. The AMA should evolve as the institution gains experience with risk management techniques and solutions.**

Evidence of meeting the use test could include, but is not limited to:

- *Providing evidence of how the institution ensures that the nature and balance of inputs into the risk measurement system are relevant and fully reflect the nature of the business.*
- *Providing evidence of how the risk measurement system becomes more responsive and robust.*

**3. The AMA should support and enhance the management of operational risk within the organisation.**

Evidence of meeting the use test could include, but is not limited to:

- *Providing evidence how decisions for improving processes and controls are made.*
- *Providing evidence that operational management objectives and activities are communicated within the organisation.*

**4. The use of an AMA should provide benefits to the organisation in the management and control of operational risk.**

Evidence of meeting the use test could include, but is not limited to:

- *Providing evidence that senior management has considered action on its receipt of information from the risk-measurement system.*
- *Providing evidence that the AMA increases transparency, risk awareness, and operational-risk management expertise, and creates incentives to improve the management of operational risk throughout the organisation.*

**4.3.3. Data**

438. The CRD requires data to be held and stored for several different purposes. Data to be used in the operational risk management and measurement systems are stored in one or more databases. These can contain data used for a single purpose or for a mix of purposes

439.

440. Institutions should have an IT system that ensures:

- Appropriate availability and maintenance of all relevant databases;
- Appropriate modelling and computing capacity; and
- Appropriate controls on the data-capture process.

441. These IT systems should be included in the institution's general contingency plans, in order to guarantee the recovery of the information. Established controls should prevent access by unauthorised persons and ensure the integrity of the data.

### **Data quality standards**

442. To ensure data quality, the independent review performed by the institution should address at least the following:

- a regular review of controls;
- a review of the systems by which the institution ensures data quality standards.

443. Institutions should perform consistency checks that include an audit trail of data sources. Significant discrepancies should be investigated.

444. Institutions should work on an ongoing basis to ensure that their data is of good enough quality to support their risk management processes and to calculate their capital requirements.

445. Institutions should define their own standards for ensuring data quality and should seek to develop and improve these over time. It is the institutions' responsibility to ensure the quality of their data. The institutions should be able to demonstrate that they achieve high standards in terms of comprehensiveness, appropriateness and accuracy of the data collected above the thresholds set. Examples of activities aiming to improve the data quality standards are:

- the construction of decision trees to assign losses to event type and business lines;
- the computation of average time between when loss events occurred and when they are captured;
- the review of the structure of input data to identify outliers or implausible values and changes from previous periods;
- periodic cross checking against material accounting data with institutions needing to identify and explain material divergences.

446. There should be minimum checks by an independent function to ensure that internal data are comprehensive and external data are

relevant. Supervisors could assess specific parts of this process to verify the conclusions reached by the independent function.

447. Institutions should have policies concerning their tolerance for any gaps in their internal data. They should also be able to fully justify their approaches to adjusting values.

### **Data documentation**

448. In order to facilitate the dialogue between institutions and supervisors on data quality standards, institutions should provide their supervisors with an adequate set of documentation. The following can be regarded as good practice:

- Data policy and statement of responsibility: institutions should establish an explicit data policy, which could be part of a general data policy.
- Institutions should document work-flows, procedures, and systems related to data collection and data storage.
- Data directory: institutions should have clear definitions of data items that are made available for inspection by supervisors.
- Database descriptions: documentation for material databases should be sufficient to allow institutions to provide supervisors with information needed to determine the soundness of the databases. For example:
  - A general description of databases (approximate size, date of construction, owner, etc.);
  - The source of the data;
  - The processes used to obtain and load the data;
  - The filters used to create and debug the database (e.g., maximum and minimum values);
  - Controls on transparency, access, consistency, etc.;
- Statement of weaknesses: institutions should prepare a global map of all the data and IT system weaknesses found during the internal validation and review process. Institutions should also state how they plan to correct or reduce the weaknesses.

#### **4.3.4. Guidelines for AMA quantitative issues, internal validation, risk transfer mechanisms and allocation**

449. The following sections provide guidance and examples related to the quantification standards for the Advanced Measurement Approach. The CRD grants institutions significant flexibility in the choice of operational risk measurement systems for generating operational risk figures for regulatory capital purposes. This generally reflects the nature of the operational risk measurement systems, as some AMA components are still evolving.
- 449a. At the moment there is a wide variety of approaches to AMA modelling. These include the Loss Distribution Approach (LDA) and the Scenario Based Approach (SBA). While LDA models tend to be built on actual loss data and SBA approaches usually rely on constructed (i.e. scenario generated) data, in practice the two methods usually overlap. Hybrid approaches are commonly found, with actual loss data often enriched by constructed data and vice versa. Thus, while some of the examples in the following paragraphs are more applicable to one approach than another (and this does not only mean LDA or SBA), the underlying principles are meant to be generally valid and should therefore be applicable to any AMA approach.
- 449b. The following paragraphs are intended (among other objectives) to promote a higher level of homogeneity and common understanding among competent authorities and to provide examples of the definitions and the interpretation of the most commonly used Operational Risk concepts. For this reason, wherever possible, definitions are provided and the terminology used is explained. Definitions and terminology should be considered as indicative for regulators and aiming at explaining common industry practice.

#### **General criteria on the AMA models**

450. The term 'operational risk class' can be used to identify a category of operational risk that is homogeneous in terms of the risks covered and the data available to analyse those risks. Examples of operational risk class could be an Event Type (ET) class, a Business Line (BL) class, a cell BL/ET class or an activity class, a legal entity class or a cause class.
451. In the CRD, the distribution of losses identified in each operational risk class is referred to as 'operational risk estimate' (Annex X, Part 3, Paragraph 11). In the following sections, the terms 'distribution' and 'estimate' are used interchangeably. The same holds true for the terms 'figures' and 'measures' (see below).

452. The 'operational risk measure' is a single statistic or parameter extracted from the operational risk estimate. Examples of measures are the Value at Risk or the Expected Shortfall. The institution's overall operational risk capital figure is derived from the combination of the operational risk estimates calculated for all the operational risk classes.
453. The model should be applied in a consistent way to comparable operational risk classes of the institution. The inputs and the way they are treated should be transparent and verifiable. The model should be robust in the sense that it includes all significant drivers of the institution's operational risk profile and it should be sensitive to material changes in the institution's operational risk profile.

#### **4.3.4.1. AMA four elements**

##### **Combination of the four elements**

454. The [Directive 2006/48/EC](#) requires operational risk measurement systems to have four key elements. Annex X, Part 3, Paragraphs 9 and 13 to 24 require institutions using the AMA to use all four elements as inputs to their operational risk measurement system.
455. The responsibility for determining how the four elements are weighted and combined rests with the institution. The processes for evaluating the availability of the four elements should be consistent with the institution's general risk management framework.
456. The model should be documented in detail and the documentation should be timely and up-to-date. In particular:
- Institutions should have internal documentation specifying in detail how the four elements are combined and/or weighted.
  - The documentation should include a description of process modelling that illustrates the use of the four elements.
- 456a. The minimum requirements for model documentation for an AMA application are set out in Paragraph 51 of these guidelines. Annex IV of these guidelines provides additional general examples of an institutions' internal documentation.

##### *Internal data*

- 456b. The term 'calculation data set' can be used to identify the part of the institution's internal operational risk data that is to be used for the generation of regulatory operational risk estimates and measures.
- 456c. The term "rapidly recovered loss event" can be used to identify an operational risk event that leads to a loss that is completely recovered in a short period.

- 456d. The term 'near-miss event' can be used to identify an operational risk event that does not lead to a loss.
- 456e. The term 'operational risk gain event' can be used to identify an operational risk event that generates a gain.
- 456f. The term 'multiple time losses' can be used to identify a group of subsequent losses occurring in different periods of time, but relating to the same operational risk event. An example of multiple time losses is a large number of mispriced transactions arising from a single incorrect piece of reference data or from a scheme to defraud using many small transactions.
- 456g. The term 'multiple-effect losses' can be used to identify a group of associated losses affecting different entities or business lines, units, etc., but relating to the same root event.

### **Loss event identification and classification**

- 456i. Institutions should have a policy that identifies when a loss or an event recorded in the internal loss events database is also to be included in the calculation data set. This policy should provide a consistent treatment of loss data across the institution. Competent authorities should obtain relevant information from the institution on its policy for loss identification and classification.
- 456j. Institutions should be able to separate operational risk events (e.g. loss, recovery) related to existing insurance policies and other risk transfer mechanisms in the calculation data set. Supervisors could allow institutions to not include the "rapidly recovered loss events" in the calculation data set.
- 456k. Multiple time losses should be aggregated into a single loss before inclusion in the calculation data set. Multiple-effect losses should also be aggregated into a single loss before inclusion in the calculation data set; possible exceptions should be documented by institutions and properly addressed to prevent undue reduction of the capital figures.
- 456l. The capture of near miss events, while not generally required to be included in the calculation data set, could nevertheless be useful in increasing awareness of the institution's operational risk profile and improving its operational risk management processes. Competent authorities could therefore encourage institutions to develop procedures that allow them to identify incidents or near misses. The capture of the operational risk gain events could also be useful for management purposes. The inclusion of the operational risk gain events in the calculation dataset should be appropriately addressed in order to avoid undue reduction of the capital figures.

456m. Annex X, Part 3, Paragraph 17 of the [Directive 2006/48/EC](#) requires institutions to set specific criteria for assigning loss data arising, among other sources, from events in a centralised function or activities that span more than one business line.

456n. The following are general examples of how this could be achieved:

- Assignment of the entire loss to the business line for which the impact is the greatest or, solely for management purposes, to a centralised function (for example 'Corporate Center').
- Proportional assignment of the losses to the affected business lines. In this case, a reference code should be used to label the individual business line loss amounts, so as to identify them for attribution to the originating specific-loss event. In any case, the aggregated amounts, and not the pro-rated amounts, should be included in the calculation data set; possible exceptions should be documented by institutions and properly addressed to prevent undue reduction of the capital figures.

### **Minimum loss thresholds**

456o. Annex X, Part 3, Paragraph 15 of the Directive 2006/48/EC requires institutions to define appropriate minimum loss thresholds for the collection of internal loss data.

456p. The institution is responsible for defining the threshold for an operational risk class. This threshold is usually determined by the inherent risk and complexity of the class, as well as by the cost-benefit analysis of collecting the data below the threshold. Nevertheless, setting the threshold requires accuracy, as it can influence the results of the model considerably. Competent authorities should pay particular attention to how institutions have set their thresholds.

456q. Institutions should be able to provide evidence to competent authorities that the threshold or thresholds selected for the operational risk classes are reasonable (for example by linking thresholds to risk tolerance), do not omit important operational loss event data, and do not adversely impact the credibility and accuracy of the operational risk measures.

456r. Competent authorities should verify that the institution avoids potential biases in the estimation of model parameters, explicitly taking into account the incompleteness of the calculation data set in the model due to the presence of threshold(s) (for example, by making use of appropriate distributions and suitable parameter estimation procedures).

## External data

- 456s. Annex X, Part 3, Paragraph 19 of the [Directive 2006/48/EC](#) states that the institution's operational risk measurement system shall use relevant external data, especially when there is reason to believe that the institution is exposed to infrequent, yet potentially severe losses.
- 456t. Consortia initiatives, which are generally set up by institutions, collect data above low thresholds, usually very close to the thresholds established internally by those institutions.
- 456u. Institutions that participate in consortia initiatives should provide data which are classified in a homogeneous manner and contain information which is comprehensive and reliable. Information obtained from consortia initiatives which have the above-mentioned characteristics can be considered an appropriate external data source for capital calculation purposes, particularly when institutions have limited internal loss data, e.g. on new businesses.
- 456v. Where external data from consortia are insufficient for obtaining information on severe tail events, especially on their causes, public sources could provide useful additional information.
- 456w. Particular care must be taken when an institution uses only public data to ensure that they are appropriate, unbiased, and relevant to the institution's businesses and operational risk profile.
- 456x. Differences in the size of institutions or other institution-specific factors should be taken into account when incorporating external data in the measurement system, for example by making assumptions as to which external loss events are considered relevant and on the degree the data should be scaled or otherwise adjusted.

## Scenario analysis

- 456y. Annex X, Part 3, Paragraph 20 of the Directive 2006/48/EC requires institutions to use scenario analysis of expert opinion, in conjunction with external data, to evaluate their exposures to high-severity events.
- 456z. The use of scenario analysis is not restricted to evaluating exposures to high-severity events. In certain approaches, scenarios may be used to provide information on the institution's overall operational risk exposure.
457. In order to generate credible and reliable data, institutions should ensure a high level of repeatability of the process for generating scenario data, through consistent preparation and consistent application of the quantitative and qualitative results.
- 457a. Institutions should ensure that the process by which the scenarios are determined is designed to reduce as much as possible subjectivity and biases. In particular:

- The assumptions used in the scenarios should be based as much as possible on empirical evidence. Relevant internal and external data available should be used in building the scenario;
- In choosing the number of scenario to apply, institutions should be able to explain the rationale behind the level at which scenarios are studied and/or the units in which they are studied;
- The assumptions for generating scenario analyses and the process by which the scenario is built should be well documented.

### **Business Environment and Internal Control Factors (BE&ICFs)**

457b. By their nature, BE&ICFs should be forward-looking and closely aligned with the quality of the institution's control and operating environment. These factors should reflect potential sources of operational risk such as rapid growth, the introduction of new products, employee turnover, and system downtime. BE&ICFs should provide information on how risk is mitigated or magnified by internal and/or external environment, and have to be appropriately captured in the risk measurement system. BE&ICFs can be incorporated into the AMA system in different ways and at different modeling stages. Key Risk indicators are one, but not the only example for BE&ICFs.

457c. Annex X, Part 3, Paragraphs 21-23 of the [Directive 2006/48/EC](#) require an institution's firm-wide risk assessment methodology to capture key business environment and internal control factors (BE&ICFs) that can change its operational risk profile. Institutions should document where in their system they use BE&ICF and their rationale for doing so.

457d. An institution's risk measurement system should incorporate at least those BE&ICFs that have a significant influence on its operational risk profile. However, when implementing the risk measurement system for the first time, it might not be possible to justify the appropriateness of the sensitivity of risk estimates because of a lack of empirical evidence on the relationship between the BE&ICFs and the operational risk exposure. In such cases, institutions should at least qualitatively justify the appropriateness of the methods used to incorporate BE&ICFs in their risk measurement system.

457e.

#### **4.3.4.2. AMA four elements: qualitative inputs**

457f. Some of the four elements – or parts of them – may contain qualitative data (or data incorporating qualitative judgement). Qualitative data generally relate to:

- An attribute, such as the quality of the control level on a trading floor, that can only be described qualitatively. Another example is the use of alternative methods such as scorecards to determine

capital requirements due to the unreliability or scarceness of statistical historical loss data.

- A quantitative situation that can only be appraised qualitatively (a 'low' or 'very low' probability).
- Internal data (the location of loss, the gender of a person committing fraud, etc.).

458. The CRD allows qualitative data to play an important role in the AMA. Despite their inherent limitations, institutions are allowed to use these data for calculating the regulatory capital requirements.

460. Institutions that use qualitative data should be able to provide evidence to their supervisors that:

- They are sufficiently skilled at handling qualitative data;
- They have done everything possible to remove biases;
- Qualitative data are relevant to precisely defined risk variables; and
- There is sufficient evidence that the qualitative data are relevant to the intended risk objectives. For example, if a qualitative scorecard is used to track internal fraud, the institution should monitor the evolution of the correlation between the score and observed fraud losses over time.

461. Supervisors should assess the relevance and appropriateness of the qualitative data used by institutions in computing their capital requirements. They should take into account the institution's motivation for using qualitative data (e.g., whether it is to incorporate forward-looking elements, to replace missing quantitative data, or to conduct scenario analysis).

#### **4.3.4.3. Consistency of the risk measurement system**

461a. Annex X, Part 3, Paragraph 12 of the [Directive 2006/48/EC](#) requires, among others things, that the risk measurement system be internally consistent.

461b. Institutions should adopt appropriate methods and procedures to guarantee the consistency and quality of the input, execution, and output phases of the model.

#### **Model input, execution and output**

461c. Institutions should seek to identify operational risk classes within which loss amounts are independent and identically distributed. Alternatively, institutions may wish to adjust their data for known drivers in order to simplify the modeling process, which needs to be justified.

461d. Where modelling requires independence of loss events, the following tools and techniques may be used (the following are intended to be non-exhaustive and non-binding examples):

- Time plots and appropriate functions, which serve, respectively, to check the level of stationarity of the data over time and to address the detected non-stationarity of the frequency and severity components.
- Techniques that reduce the effects of data clustering and seasonality and that adjust the data for inflation.
- Qualitative criteria (based, for example, on the qualitative information relating to the data) and/or quantitative tests to detect outliers and techniques to eliminate or mitigate their influence.

461e. The execution of models for generating regulatory operational risk figures should be supported by a transparent and consistent process. Depending on the modelling methodology chosen, institutions could take the following steps which are to be intended neither exhaustive nor binding:

1. Preliminary identification of a set of probability distributions to be fitted to the data.
2. Appropriate techniques for estimating parameters.
3. Appropriate diagnostic tools for evaluating how well the distributions fit the data.
4. Sound methods for selecting distributions, when the results from point 3 do not indicate a clear choice.

461f.

461g. In order to determine an overall operational risk capital figure that is credible and justifiable, the model should be built in a way that ensures the production of results that are as stable as possible. In addition, institutions should be able to evaluate the accuracy of the operational risk capital figures.

461h. Some of the elements that institutions could take into consideration when calculating operational risk capital figure are presented in Annex VII of these guidelines.

### **Observation period**

461k. Annex X, Part 3, Paragraph 13 of the Directive 2006/48/EC requires institutions to base their internally generated operational risk measures on a minimum historical observation period of five years (three years when an institution first moves to an AMA).

461l. A low-frequency operational risk class may need a historical observation period longer than five years in order to collect sufficient data to generate reliable operational risk measures.

461m. General examples of methods that institutions could use to obtain a sufficient amount of data reflecting the current operational risk profile include the following:

- Reducing the impact of oldest, least relevant internal data by appropriate weighting techniques (e.g. moving average); using quantitative indicators (e.g. inflation or business/structure risk drivers) or qualitative factors that reflect changes in the institution's internal/external environment.
- Supplementing the most recent years of internal data with the corresponding years of external data from similar institutions/peer groups, after appropriate adjustments to the external data.
- Constructing data for operational losses in past years by means of scenario generated data or by scaling back more recent years of internal/external observations through appropriate techniques or indicators.

461n In the absence of sufficient data, institutions should make conservative risk estimates.

### **Confidence level**

461o. Annex X, Part 3, Paragraph 8 of the [Directive 2006/48/EC](#) states that the regulatory operational risk measure must capture potentially severe tail events, achieving a soundness standard comparable to a 99.9 percent confidence level.

461p. In order to generate a regulatory operational risk measure at a soundness standard comparable to a 99.9 percent confidence level, institutions can perform a direct calculation at the 99.9 percent confidence level, or they can calculate an initial measure at a lower confidence level, located in the right end of the loss distribution, and then scale it up to the 99.9 percent confidence level using appropriate methods.

461q. The institution should be able to demonstrate that the scaling method yields an output that is plausible and reliable. The confidence level used should not necessarily be interpreted as a boundary between the body and the tail of the distribution.

461r. The confidence level at which the initial operational risk measure can be computed should be located in the right-end of the distribution of the losses. The level should be appropriate.

461s. If scaling is used, institutions should be able to demonstrate the soundness, appropriateness, and reliability of the scaling technique and to analyse the overall accuracy of the scaling mechanism.

461t. The following are examples of techniques that can be used to scale an initial calculation at a confidence level below 99.9 percent to a level comparable to 99.9 percent:

- Imposing a reasonable distribution for the highest percentiles of the data, based, for example, on information collected by peer groups or scenario analysis.
- If an Extreme Value Theory approach is used, resorting to the stability property of the model (the so-called 'Peaks over Threshold' stability property) that makes it possible to compute the highest percentiles of the frequency and severity distributions from figures estimated at a lower level (usually at the threshold level).

#### **4.3.4.4. Expected losses, correlation, Insurance and other Risk transfer mechanisms**

##### **Expected losses**

461u. Annex X, Part 3, Paragraph 8 of the [Directive 2006/48/EC](#) states that institutions shall calculate their capital requirement as comprising both expected loss (EL) and unexpected loss (UL), unless they can demonstrate that EL is adequately captured in their internal business practices.

461v. CEBS endorses the following four general principles for the treatment of EL by institutions using the AMA, as described in the Basel Committee's Newsletter n. 7 of November 2005 ("[The treatment of expected losses by banks using the AMA under the Basel II Framework](#)").

1. For EL to be measured to the satisfaction of national supervisors, the institution's estimate of EL should be consistent with the EL-plus-UL capital requirement calculated using the AMA model approved by supervisors. For EL to be captured to the satisfaction of national supervisors by means other than holding capital or establishing provisions, the institution should be able to demonstrate that the corresponding losses are highly predictable and reasonably stable, and that the estimation process is consistent over time.
2. The maximum offset for EL should be bounded by the EL exposure calculated by the institution's AMA model approved by supervisors. While many supervisors may interpret this maximum offset as a statistical measure of expected loss over the entire loss distribution, some supervisors may choose a more restrictive maximum offset.
3. Allowable offsets for EL should be clear capital substitutes or otherwise available to cover EL with a high degree of certainty over a one-year time horizon. Where the offset is something

other than provisions, its availability should be limited to those operations with highly predictable, routine losses. Because exceptional operational risk losses do not fall within EL, specific reserves for any such events that have already occurred will not qualify as allowable EL offsets.

4. The institution is expected to clearly document how its EL is measured and captured, including how any EL offsets meet the conditions outlined above.

461w. The principles articulated in this note are designed to be flexible enough to allow for a range of sound practices and to encourage continued work in this area, while also clarifying CEBS' expectations.

## **Correlation**

461x. Annex X, Part 3, Paragraph 11 of the [Directive 2006/48/EC](#) states that correlations in operational risk losses across individual operational risk estimates may be recognised only if credit institutions can demonstrate to the satisfaction of the competent authorities that their systems for measuring correlations are sound, implemented with integrity, and take into account the uncertainty surrounding such correlation estimates, particularly in periods of stress.

461xa Institutions who explore and recognise "correlations" in their AMA models should take into account of the following considerations (para 461 y to 462 f). Institutions who do not explore "correlations" in their AMA models have to calculate the overall capital requirement as the sum of the individual operational risk measures arising from different operational risk losses.

461y. As noted in paragraphs 461c – 461d of these guidelines, each operational risk estimate should be built on a set of loss events and loss amounts (actual or constructed) that are, to the maximum extent possible, independent. Thus, in the context of the CRD requirement mentioned in the preceding paragraph, the term 'correlation' should refer to the relationships between (actual or constructed) data belonging to different operational risk classes.

461z. In operational risk, correlations may arise because of the presence of common factors of different nature, either idiosyncratic (e.g. processes, systems, and people) or due to environmental elements that affect several geographical, business, or legal units. These factors can influence the observed frequency or severity of losses in more than one operational risk class.

462. The term correlation, as used in the CRD, should be interpreted broadly to mean any form of dependency (e.g. linear or non-linear, relating to all the data or just to the body or the tail) across two or more operational risk classes, caused by internal and/or external factors. Model documentation should identify and justify assumptions

relating to correlation, and should evaluate the model's sensitivity to those assumptions (see also Annex VIII of these guidelines).

462a. Low-frequency, high-severity events are usually the main drivers of risk estimates used in AMA models. Dependencies between such tail events should be studied with great care. Given the different nature of tail and body events, different quantitative and qualitative tools could be necessary to determine and estimate the impact that the underlying dependency structures will have on capital.

462b.

462c. Dependencies, in both quantitative (e.g. LDA) and qualitative approaches (e.g. SBA or others) should, to the maximum extent possible, be identified, and treated directly in the input information. Procedures to minimise the impact of such dependencies should be applied and documented as clearly as possible. In techniques based on loss data, this can be achieved, for example, through quality control or treatment of the loss databases<sup>75</sup>; and in qualitative approaches, through appropriate selection of the scenario<sup>76</sup> or self-assessment questionnaires.

462d. Annex X, Part 3, Paragraph 11 of the [Directive 2006/48/EC](#) also states that *"The credit institution must validate its correlation assumptions using appropriate quantitative and qualitative techniques"*.

462e. Validation with quantitative techniques developed for correlations between high-frequency, low-severity events could be difficult to apply to dependencies between tail events.

462f. In these cases, the soundness of dependency assumptions that have a material impact on the overall AMA measure should be demonstrated by using, at a minimum, qualitative validation techniques; and, where possible, quantitative techniques and/or some form of stress-test analysis.

### **Insurance and other Risk Transfer Mechanisms**

462g. Competent authorities would be expected to apply an appropriate level of standards for the recognition of other risk transfer mechanisms.

462h. Outsourced activities should not be considered part of other risk transfer mechanisms.

462i. Institutions should keep their use of insurance and other risk transfer mechanisms under review and recalculate the operational risk capital

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<sup>75</sup> For instance, integrating data which show strong cross dependencies into a single data point.

<sup>76</sup> For instance, by considering uncorrelated, independent, causal factors.

charge if appropriate in the event that the nature of the insurance or the coverage of other risk transfer mechanisms changes significantly.

462j. Institutions should notify competent authorities of material changes in the coverage of insurance or other risk transfer mechanisms.

463.

#### **4.3.4.5. Internal validation of risk measurement and management processes**

463a. This section examines the scope of AMA internal validation to be undertaken by institutions, and provides guidance to competent authorities on the types of internal validation and assurance techniques that institutions could apply. It does not propose guidance for competent authorities on how they should conduct their own assessments.

463b. The following high-level principles apply to validation:

1. Internal validation is the responsibility of the institution. The institution should make a 'best effort' to internally validate its AMA framework.
2. Institutions should establish a clear methodology for internal validation. This methodology should be appropriate for the organisation and its AMA framework, and should be clearly documented.
3. There is no single validation method. Internal validation techniques should be proportionate and take into account changing market and operating conditions.
4. Internal validation should encompass both quantitative and qualitative elements.
5. Internal validation processes and outcomes should be subject to independent review to ensure that implementation is effective.

463c. The frequency of internal validation will ultimately depend on what is being validated and on its significance in the institution's risk measurement systems or risk management processes. Institutions should conduct a complete internal validation programme, including independent review of the internal validation processes and outcomes, before submitting the AMA application (i.e., at the model development stage).

463d. Institutions should periodically analyse their internal validation methodology to ensure that it remains appropriate. In particular, certain parts of the risk measurement systems and risk management processes should be revalidated, at least if there is a significant change in the institution's operational risk profile and/or in the model's methodology/assumptions or management processes.

## **Validation of Risk Measurement Systems**

- 463e. Validation of operational risk measurement systems presents major challenges to institutions. Nevertheless, an institution has to have an internal validation process. This should be proportionate and should take into account the specific purpose for which the operational risk measurement systems are used.
- 463f. Institutions should ensure that information that is fed into the risk measurement systems is as accurate and complete as reasonably practicable.
- 463g. There are many methods that can be used for validation; and, as institutions gain experience, new validation techniques will emerge. An institution should consider a robust approach to validation and should be able to explain and justify its methodology. An institution's internal validation of its risk measurement systems should encompass both quantitative and qualitative elements and be clearly documented. This documentation should provide a detailed outline of the validation methodology (including frequency), and outline any identified weaknesses.
- 463h. The following paragraphs describe the minimum validation requirements that competent authorities should expect institutions to satisfy in the relevant areas of the risk measurement systems.

## **Model input, methodology and output**

- 463i. The institution should have clear standards for the input of data into its model, to which it must adhere (as already mentioned in other parts of these guidelines, e.g. section 4.3.3.).
- 463j. All material data above the thresholds set must be validated to ensure that they are comprehensive, appropriate, and accurate. Validation should cover all data types: actual data, constructed data, figures generated by scenario analysis, factors relating to business environments, and internal control factors. Particularly for constructed data, the validation should ensure that the assumptions are unbiased and the results are realistic.
- 463k. The institution should ultimately be able to ensure the validity of the model input on an ongoing basis.
- 463l. Annex VI, Part 1 of these guidelines provides a list of general examples for internal validation of internal and external data, as well as for data and/or figures generated by scenario analysis, and business environments and internal control factors.
- 463m. Model validation should ensure that the relationship between the inputs and outputs of the model are stable and that the techniques underlying the model are transparent and intuitive. The model

should be logical: if controls are improved, then EL and/or UL should decrease; and hence, all other things remaining equal, there should be a corresponding reduction in regulatory capital.

463n. The institution should be able to ensure the validity of the model methodology at the development stage and following significant changes in methodology/assumptions, and it should be able to ensure the validity of the model output on an ongoing basis.

463o. Annex VI, Part 2 of these guidelines provides a list of general examples of internal validation of model methodology and model output.

### **Validation of Risk Management Processes**

463p. Institutions should have robust risk management processes for managing operational risk throughout the business. Institutions will be expected, as part of the internal validation process, to assess the appropriateness of their risk management processes. This is to ensure that the framework remains 'fit for purpose' and operates as management would expect it to.

463q. Validation of the risk management processes should be an ongoing exercise. Institutions should be able to justify to competent authorities how they do this. Institutions can use a variety of validation techniques. These include verifying that:

- Risk management documentation is complete.
- Management information reporting procedures are followed.
- Captured loss data meet the required data standards.
- Follow-up actions are carried out in an effective and timely manner.
- Procedures to review and update the operational risk management framework are followed.
- KRI's/loss data/compliance reports and risk estimates are in line with the results of qualitative self-assessments.

#### **4.3.4.6. Allocation methodology for AMA institutions on a group-wide basis**

464. When an EU parent institution and its subsidiaries, or the subsidiaries of an EU parent financial holding company, intend to use the AMA to calculate operational risk capital requirements on a group-wide basis, their application shall include a description of the methodology that will be used to allocate operational risk capital between the different entities of the group (Annex X, Part 3, Paragraph 30 of the [Directive 2006/48/EC](#)). This methodology must allocate capital from the

consolidated group level downwards to subsidiaries that are involved in the consolidated AMA calculation process. Institutions should demonstrate that they have sound and rational methodologies for allocation and that they are implemented consistently, fairly, and with integrity. Institutions are strongly encouraged to move towards allocation mechanisms that properly reflect the operational riskiness of the subsidiaries and their actual contribution to the consolidated capital charge. The allocation mechanism should be a significant component of the assessment of the application by the home supervisor and relevant host supervisors.

#### 4.3.5. Internal governance

465. Operational risk management differs from credit risk management, reflecting fundamental conceptual differences between operational risk and credit risk.
466. Operational risk is inherent in every activity performed by an institution and in every part of its organisation, while credit risk is localised in portfolios. Credit risk is actively taken, in order to generate income, while operational risk is inherent in every activity performed by an institution. The amount of credit risk that an institution wants to take on can be defined and controlled using a limit system, while it is difficult to set limits for operational risk (although it can be mitigated by insurance and/or internal controls).
467. Article 105(1) and (2) of the Directive 2006/48/EC provides that permission to calculate operational risk capital requirement using the AMA can be given only if the competent authority is satisfied that the institution meets the qualifying criteria in Annex X, Part 3 of the Directive 2006/48/EC.
468. In particular, with regard to internal governance matters, the following elements have to be taken into account:
- **Reporting:** there should be a regular reporting on operational risk exposures and loss experience. The institution shall have procedures for taking appropriate corrective actions. (Annex X, Part 3, Paragraph 4).
  - **Operational risk management function:** the institution should have an independent risk management function for operational risk. (Annex X, Part 3, Paragraph 3).
  - **Internal Audit:** the operational risk management processes and measurement systems shall be subject to regular reviews performed by internal and/or external auditors (Annex X, Part 3, Paragraph 6).

## **Hierarchy of responsibility, management body and senior management**

469. Sound internal governance requires that the decision-making process be clearly stated within each institution, in terms of hierarchy and level of responsibility. In order to improve understanding of the operational risk measurement system among the members of the management body, and to improve efficiency, the management body may, where appropriate, establish specific Risk Committees and delegate certain aspects of this framework to these committees or to senior management. Senior management itself may also delegate certain tasks. However, such delegations do neither relieve the management body and senior management from their obligation to have a general awareness of the AMA framework used by their institution, nor do they relieve the management body from its ultimate responsibility for the AMA framework and the senior management from its responsibility for developing and implementing it.
470. Both the management body and senior management should be responsible for approving all material aspects of the overall operational risk framework. They should have a general understanding of the institution's operational risk measurement systems and detailed comprehension of its associated management reports submitted to them and how operational risk affects the institution. The material aspects of the overall operational risk framework encompass:
- Activities aimed at identifying, assessing and/or measuring, monitoring, controlling, and mitigating operational risk
  - Proactive risk management strategies and policies;
  - The organisational structure of the control functions; and
  - Specifying levels of acceptable risk.
471. Both the management body and senior management are responsible for making formal decisions on the implementation of the AMA approach. This includes the overall approval of the project, the specification of goals, and the appointment of the organisational structures responsible for implementation. A time schedule of the necessary steps and an estimation of related costs and benefits should be provided with the project approval.
472. The management body has to exercise effective oversight. Senior management should therefore notify the management body, or a designated committee thereof, of material changes or exceptions from established policies that will materially impact the institution's operational risk measurement systems and management processes.

473. Both the management body and senior management should be involved, on an ongoing basis, in the oversight of the control procedures and measurement systems adopted by the operational risk management function, to ensure that they are adequate and that the overall operational risk management and measurement processes and systems remain effective over time. For the same reason the management body should be involved, on an ongoing basis, in the oversight of the control procedures of Internal Audit.
474. Senior management should ensure that the following tasks are being addressed:
- Ensuring the soundness of risk management processes;
  - Informing the management body – or a designated committee thereof – of material changes or exceptions from established policies that will materially impact the operations and the operational risk profile of the institution;
  - Identifying and assessing the main risk drivers, based on information provided by the operational risk management function;
  - Defining the tasks of the risk management unit and evaluating the adequacy of its professional skills;
  - Monitoring and managing all sources of potential conflicts of interest;
  - Establishing effective communication channels in order to ensure that all staff are aware of relevant policies and procedures;
  - Defining the content of reporting to the management body or to different delegated bodies thereof (e.g., the Risk Committee);
  - Examining reports from Internal Audit on operational risk management and measurement processes and systems; and
  - Adequately assessing operational risk inherent in new areas (products, activities, processes, and systems) before they are introduced, and identifying risks tied to new product development and other significant changes in order to ensure that the risk profiles of product lines are updated regularly.
475. The operational risk management function designs, develops, implements, and executes risk management and measurement processes and systems.
476. The Internal Audit should provide an assessment of the overall adequacy of the operational risk framework, as well as of the operational risk management function.

## Internal reporting

477. Operational risk reporting should be an essential part of the internal reporting system and should support the proactive management of operational risk. The recipients of the reporting should be the management body, senior management, Internal Audit, the Risk Committee and/or the Internal Control Committees (where established), and, where appropriate, the internal functions responsible for the identifying, assessing, monitoring, mitigating, and controlling operational risks. These internal functions could include, for example, business functions, central functions (such as IT, Plan and Management control, and accounting), and risk functions.
478. The frequency and content of reporting should be formally approved by both the management body and senior management. Senior management should ensure the ongoing appropriateness of the reporting framework.
479. The frequency, content, and format of reporting should depend on the recipient and on how the information will be used. Possible uses include strategic and financial planning, day-to-day management, operational risk management and measurement, market disclosure, etc.
480. The scope of information included in internal reporting may vary according to the nature, size, and degree of complexity of the business, as well as of the institution. As a general rule, the riskier the business, the more detailed the information to be provided. The frequency and format of the internal reporting should be consistent with the level of risk.
481. The design of the reporting framework is the responsibility of the institution. However, reporting could include:
- Estimates of regulatory and economic capital;
  - New or improved management policies, procedures, and practices (e.g., changes in the business environment, business practices, and internal control factors);
  - Risk reduction and risk transfer strategies (e.g., the effect of any expected loss deductions, cost-benefit analysis of insurance policies, mitigation and corrective actions on the business line/event type exposure and/or losses, cost-benefit analysis of the mitigation actions);
  - Operational risk exposure (e.g., description of key operational risk events and drivers, and the distribution, trend, and migration of the operational risk exposure across business lines);

- Internal and (where relevant) external loss experience (e.g., event type loss analysis and comparison in term of trends, seasonality, geographical distribution, etc.);
- Identification and assessment of vulnerability areas (e.g., risk assessments, key risk indicators); and
- Quality improvements in operational risk management and measurement processes and systems.

### **Operational risk management function**

482. The Operational risk management function (ORMF) should ensure, on a regular basis that the institution's operational risk measurement processes and risk management systems and all of their components are functioning as intended. The ORMF should have sufficient resources and skills in operational risk management and measurement methods and knowledge of the processes of the institution.
483. The Operational risk management function should ensure that the following tasks and areas (among others) are performed or covered on a ongoing basis:
- The processes related to the definition, documentation, and collection of the four AMA elements;
  - Measurement methodology;
  - Monitoring and reporting systems;
  - Verifying the fulfilment of the qualifying criteria, and, in particular, of the use test;
  - Operational risk quantification and allocation processes, including the calculation of any haircuts (EL, dependence, insurance), where sufficient data are available, backtesting and benchmarking, and the methodology for the allocation keys.
484. The CRD does not specify how and where the internal validation of the AMA measurement models should take place. Ideally, the people responsible for the internal validation of measurement systems and management processes should not be the same as the people responsible for their design (see paragraph 362, which introduces a similar principle in the context of credit risk). However, on an exceptional or temporary basis, it can be acceptable that the role of validation of the AMA measurement systems and management processes is undertaken by the same function as the one involved in designing, developing, and implementing the operational risk framework.

485. Any potential lack of objectivity should be offset by an independent review, as required by the fifth principle of paragraph 463b. Institutions are encouraged to move to an independent internal validation process as soon as possible.
486. Any attempt to specify where in the organisational structure of an institution the ORMF should be located could be to some extent counterproductive, for the following reasons:
- The activities of the ORMF could span multiple areas and business units;
  - Institutions will choose a structure that fits their management and oversight frameworks.
487. Institutions generally have a central operational risk unit and some operational risk staff in the local entities (units, businesses, etc.). Where this is the case, the institution should ensure that the local operational risk staff follows the guidelines set by the central operational risk unit. There should be clear responsibilities and reporting lines. The Internal Audit should perform specific examinations in order to assess the 'real' degree of independence of the ORMF.

### **Internal Audit**

488. The central role of Internal Audit's review of the operational risk management framework is to ensure the effectiveness of the institution's operational risk management processes and measurement systems and the work of the ORMF, and to verify compliance with the AMA standards.
489. As part of its activities, Internal Audit should develop a programme for reviewing the operational risk framework that covers all significant activities – including outsourced activities – that expose the institution to material operational risk. This programme should be regularly updated with regard to:
- Development of internal processes for the identifying, assessing, monitoring, controlling, and mitigating operational risk; and
  - Implementation of new products, processes, and systems which expose the institution to material operational risk.
490. Internal Audit activity should also cover issues such as the adequacy of the IT infrastructure, data collections, and data maintenance. Specific tests should be performed in order to check the data input process.
491. Internal Audit functions should be staffed by individuals possessing the requisite skills and experience. It is important that they be familiar with the institution's strategy and its processes for identifying, assessing, monitoring, controlling, and mitigating operational risk.

492. Some cooperation between Internal Audit and the ORMF is permissible, especially in some operational risk-related activities and processes where Internal Audit's experience and skills are well developed (for example, analysis of processes, loss data collections, risk and control assessments, etc.). However, cooperation with the ORMF should not jeopardise the independence of Internal Audit. Whatever advice or information may be provided by Internal Audit, designing, implementing, and updating the operational risk framework remains the exclusive responsibility of the ORMF, and Internal Audit should not be involved in day-to-day operational risk activities.

## 5. ANNEXES

### ANNEX I

#### **Practical framework: model approval**

##### *Step 1 – Pre-application*

| Cross-border implications                                                                                                                      | Tasks or considerations for the consolidating supervisor                                                                                                                                                                                                                                               | Tasks or considerations for the host supervisor                                                                                                                                                                                   |
|------------------------------------------------------------------------------------------------------------------------------------------------|--------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|-----------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| <ul style="list-style-type: none"> <li>• The group has exploratory discussions with individual supervisors about the use of models.</li> </ul> | <ul style="list-style-type: none"> <li>➤ There is no formal requirement that other supervisors need be informed at this stage. However, supervisors are advised to communicate the outcomes of their exploratory discussions.</li> </ul>                                                               | <ul style="list-style-type: none"> <li>➤ There is no expectation that other supervisors need be informed at this stage, although, at a minimum, informal contact with the consolidating supervisor would be advisable.</li> </ul> |
| <ul style="list-style-type: none"> <li>• The group expresses a clear intention to move towards the advanced approaches.</li> </ul>             | <ul style="list-style-type: none"> <li>➤ The consolidating supervisors should advise the relevant host supervisors.</li> </ul>                                                                                                                                                                         | <ul style="list-style-type: none"> <li>➤ Inform the consolidating supervisor that local institutions are contemplating the use of internal models.</li> </ul>                                                                     |
| <ul style="list-style-type: none"> <li>• Consultative framework</li> </ul>                                                                     | <ul style="list-style-type: none"> <li>➤ Plan and organise a consultative framework to include:               <ul style="list-style-type: none"> <li>- A communication strategy for all supervisors, and</li> <li>- A mechanism enhancing a common agreement among supervisors.</li> </ul> </li> </ul> |                                                                                                                                                                                                                                   |

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|-------------------------------------------------------------------------------------------------------------------|----------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|----------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| <ul style="list-style-type: none"> <li>• Understanding the extent and nature of the group's intentions</li> </ul> | <ul style="list-style-type: none"> <li>➤ Discuss with the group the intentions to implement an internal models approach.</li> <li>➤ Produce a preliminary assessment of the group's proposals, including: <ul style="list-style-type: none"> <li>- The readiness of the group, and</li> <li>- The adequacy of plans.</li> </ul> </li> <li>➤ Communicate the salient features to the supervisors likely to be affected by the group's intentions, and inform other supervisors of the group's plans in accordance with the general communication strategy.</li> <li>➤ Collate the concerns and issues of other supervisors with the proposed approach and produce a summary of the principal issues.</li> </ul> | <ul style="list-style-type: none"> <li>➤ Communicate concerns and issues with the proposed approach.</li> <li>➤ Need to identify potential disagreements so that supervisors can have an early plan to address.</li> </ul> |
| <ul style="list-style-type: none"> <li>• Supervisory plan of action</li> </ul>                                    | <ul style="list-style-type: none"> <li>➤ Draw up the supervisory plan in consultation with other relevant supervisors and in cooperation with the group. The plan should include: <ul style="list-style-type: none"> <li>- Identification of significant models and proposed roll-out plans;</li> <li>- The allocation of workload with respect to the significant models; and</li> </ul> </li> </ul>                                                                                                                                                                                                                                                                                                          |                                                                                                                                                                                                                            |

|  |                                                                                                                                                                                                                                                                                                                                |  |
|--|--------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|--|
|  | <ul style="list-style-type: none"> <li>- Priority issues;</li> <li>- A timetable;</li> <li>- Standards for judging the completeness and accuracy of the application;</li> <li>- Standards for reaching agreement on a final decision;</li> </ul> <p>➤ Communicate the salient points of the supervisory plan to the group.</p> |  |
|--|--------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|--|

*Step 2 – Formal application*

| Cross-border implications                                                        | Tasks or considerations for the consolidating supervisor                                                                                                                                                                                                                                                                                                                                                                                                                        | Tasks or considerations for the host supervisor |
|----------------------------------------------------------------------------------|---------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|-------------------------------------------------|
| <ul style="list-style-type: none"> <li>• Formal application submitted</li> </ul> | <p>➤ Determine promptly if the application is obviously incomplete (e.g., significant omissions of specified information). If so:</p> <ul style="list-style-type: none"> <li>- Communicate to the group that the application is incomplete, setting out the reasons why and what further information the group may need to submit.</li> <li>- Inform the other supervisors that an application has been received, that it is incomplete, and that the group has been</li> </ul> |                                                 |

|  |                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                             |                                                                                                                                                                                                                                                                  |
|--|---------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
|  | <p>asked to provide further information.</p> <ul style="list-style-type: none"> <li>➤ If not, inform the other supervisors promptly that an application has been received and distribute the application form, in whole or part, as previously agreed.</li> <li>➤ Assess the completeness and accuracy of the application against pre-agreed standards, and in consultation with the host supervisors with respect to local models.</li> <li>➤ Communicate the final results of the assessment to the group and to other supervisors. <ul style="list-style-type: none"> <li>- If the application is found to be incomplete, communicate that finding to the group, setting out the reasons why and what further information the group may need to submit.</li> <li>- If the application is complete, inform the other supervisors that the six-month period has started, and initiate the next step in the process.</li> </ul> </li> </ul> | <ul style="list-style-type: none"> <li>➤ Assess those aspects of the application that the host is best able to comment on (e.g., relating to locally developed models) and communicate the results of the assessment to the consolidating supervisor.</li> </ul> |
|--|---------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|

*Step 3 – Model assessment*

|              |                                               |                                                 |
|--------------|-----------------------------------------------|-------------------------------------------------|
| Cross-border | Tasks or considerations for the consolidating | Tasks or considerations for the host supervisor |
|--------------|-----------------------------------------------|-------------------------------------------------|

| implications                                                                                | supervisor                                                                                                                                                                                                                                                                                                                                                                                     |                                                                                                                                                                                                                                                                                                                                                                                                                                             |
|---------------------------------------------------------------------------------------------|------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|---------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| <ul style="list-style-type: none"> <li>• Performing the work</li> </ul>                     | <ul style="list-style-type: none"> <li>➤ Lead the assessment of centralised models and some local models (where agreed), the governance of the group, the role of the Board and Senior Management, and centralised risk management functions.</li> <li>➤ Assess compliance with the Use Test.</li> <li>➤ Assess self-assessment.</li> <li>➤ Assess the roll-out plan, if applicable</li> </ul> | <ul style="list-style-type: none"> <li>➤ Lead the assessment of local models (where agreed), the governance of the local entities, and local risk management functions.</li> <li>➤ Assess compliance with the Use test with respect to local models</li> </ul>                                                                                                                                                                              |
| <ul style="list-style-type: none"> <li>• Reporting the results of work performed</li> </ul> | <ul style="list-style-type: none"> <li>➤ Collate progress reports and assess the overall level of progress.</li> <li>➤ Assess whether the supervisory plans need to be revised.</li> <li>➤ Report overall progress to host supervisors in accordance with the agreed supervisory plan.</li> </ul>                                                                                              | <ul style="list-style-type: none"> <li>➤ Provide the consolidating supervisor with progress reports on the work in accordance with the agreed supervisory plan.</li> <li>➤ Inform the consolidating supervisor immediately in the event of: <ul style="list-style-type: none"> <li>- Significant failings identified in the model application process.</li> <li>- If there is a risk that deadlines will not be met.</li> </ul> </li> </ul> |

*Step 4 – Decision*

| Cross-border implications                                                     | Tasks or considerations for the consolidating supervisor                                                                                                                                                                                                                     | Tasks or considerations for the host supervisor                                                                                                                                                                                                                              |
|-------------------------------------------------------------------------------|------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| <ul style="list-style-type: none"> <li>• Agreement decision of</li> </ul>     | <ul style="list-style-type: none"> <li>➤ Agree on decisions.</li> <li>➤ Agree on any terms and conditions to be attached to the decision.</li> <li>➤ Agree on the process for handling roll-out.</li> <li>➤ Agree on the timeframe for implementing the decision.</li> </ul> | <ul style="list-style-type: none"> <li>➤ Agree on decisions.</li> <li>➤ Agree on any terms and conditions to be attached to the decision.</li> <li>➤ Agree on the process for handling roll-out.</li> <li>➤ Agree on the timeframe for implementing the decision.</li> </ul> |
| <ul style="list-style-type: none"> <li>• Communication decision of</li> </ul> | <ul style="list-style-type: none"> <li>➤ Draw up a fully reasoned decision document in accordance with agreed principles for convergence.</li> </ul>                                                                                                                         |                                                                                                                                                                                                                                                                              |

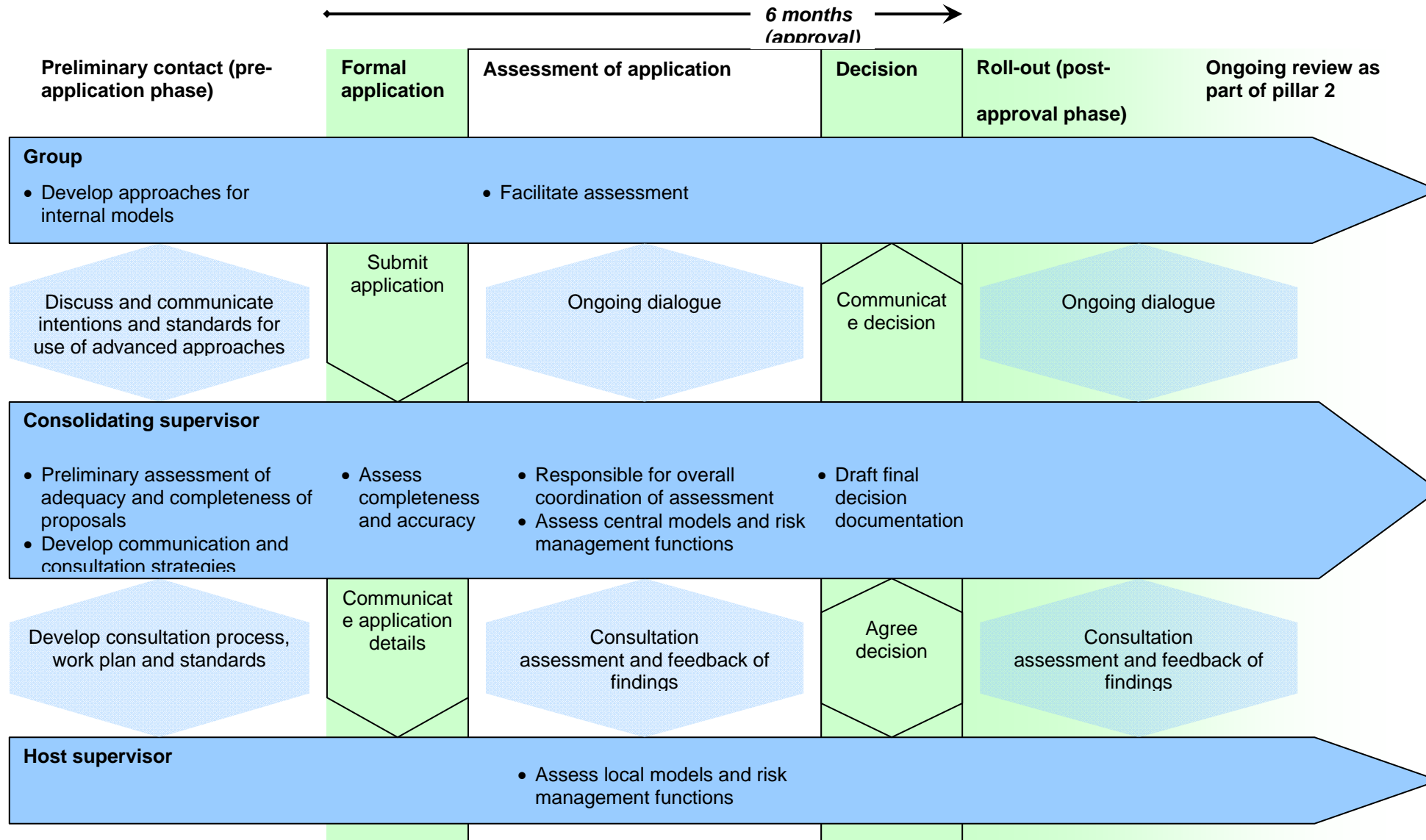
*Step 5 – Implementation*

| Cross-border implications                                                              | Tasks or considerations for the consolidating supervisor                                                            | Tasks or considerations for the host supervisor                                                                     |
|----------------------------------------------------------------------------------------|---------------------------------------------------------------------------------------------------------------------|---------------------------------------------------------------------------------------------------------------------|
| <ul style="list-style-type: none"> <li>• Implementation decision of</li> </ul>         | <ul style="list-style-type: none"> <li>➤ Implement the decision in accordance with national legislation.</li> </ul> | <ul style="list-style-type: none"> <li>➤ Implement the decision in accordance with national legislation.</li> </ul> |
| <ul style="list-style-type: none"> <li>• Planning, assessing, and reporting</li> </ul> | Follow similar procedures to step 3.                                                                                | Follow similar procedures to step 3.                                                                                |

*Step 6 – On going review*

- The ongoing review of the continuing appropriateness of the models in use shall be conducted within the Pillar 2 framework. The framework for supervisory cooperation should follow the steps outlined above.

Annex II



2.1.

## ANNEX III

- 1) “Pass-through” transactions.** These are transactions that transfer risk in a pattern different from the typical tranching of risk. In pass-through structures, all of the securities issued rank 'pari passu' (each holder is in the same position as if he held a proportional part of the underlying pool). They do not transfer different levels of risk to different investors, but simply 'pass through' some level of risk to all investors, and thus could be seen as a form of syndication rather than a securitisation. Examples of this type of transaction are US MBS structures and some covered bond structures. In some cases, the structure comes with a guarantee or other form of credit enhancement (e.g. over-collateralisation) provided by the originator or by an agency that covers the first loss. Market participants view these transactions as securitisations. They fall under the regulatory securitisation treatment if their structure includes a first-loss position tranche or credit enhancement (guarantee, over-collateralisation etc) in addition to the bonds. In that case, the requirement that a securitisation include at least two tranches is satisfied. However, if there is no first-loss position, then the transaction does not fall under the securitisation framework for regulatory purposes.
- 2) Covered bonds.** According to the current exposure class definitions, covered bonds, within the meaning of Annex VI, Part 1, Paragraph 68 of the [Directive 2006/48/EC](#), do not qualify as securitisations for regulatory purposes, because they do not include at least two different levels of risk, and because they are recourse obligations issued by a institution and not by a bankruptcy-remote SPE. However, the funding purpose served by covered bonds may be similar to that of traditional securitisation, and, to a lesser extent, of synthetic securitisation, although their regulatory treatment is quite different. The difference in regulatory treatment could induce institutions to look for arbitrage opportunities. In some countries, securitisation positions and covered bonds are interlinked. For example, covered bonds collateralised by mortgage loans have been securitised, issued by the institutions, and bought by an instrumental firm that sells them to an SPV. The SPV issues two series of bonds (usually AAA and A). The structure also benefits from subordinated loans, usually from the institutions that originally held the mortgage loans. Institutions use this structure as a way of obtaining funding at lower cost than pure covered bonds, since it receives higher ratings. Such structures fall within the definition of securitisation, since there are at least two tranches of risk.
- 3) Tranched cover.** This transaction provides partial protection to a loan. The institution buys funded protection (Credit-Linked Notes)

or unfunded protection (guarantees or Credit-Default Swaps) to cover only part of the risk of a loan, but the protected and unprotected parts do not have the same seniority. Such transactions must be treated under securitisation rules since they create two different tranches of risk. In contrast, if the protected and unprotected parts have equal seniority, CRM rules for partial cover must be applied. In the case of maximum-value guarantees, if the borrower's overall exposure to the institution exceeds the value of the guarantee, boundary issues could arise if the guarantee is drawn after workout.

- 4) Specialised lending (SL).** The need for particular attention to the boundary between securitisation and SL (specifically, Project Finance and Income-Producing Real Estate) arises from the fact that the scope of application of the securitisation treatment does not depend on more than one underlying credit risk exposure being subject to a tranching transfer of credit risk. Senior-subordinate financing structures are common in some parts of the specialised lending business, with the senior-subordinate structure not necessarily limited to the priority of claims on liquidation proceeds upon default of the borrowing entity, but also encompassing contractual clauses on the deferral of payments to the creditor of the subordinated loan. Furthermore, it is quite common to vest the subordinate creditor with the right to initiate and control liquidation procedures or to require the senior loan creditor to assign the senior loan to the subordinated loan creditor.

The supervisory rationale for providing a separate treatment for securitisation exposures was to preclude institutions using own-estimates of asset correlations at this time for regulatory purposes. From a risk-assessment and management perspective, an institution involved in a senior-subordinate SL financing may well be able to determine a borrower's PD and a facility's LGD (taking into account the claim of any more senior creditors on liquidation proceeds) without estimating asset correlations internally. A possible criterion could be: if the tranching instruments themselves *generate the 'underlying' payment obligation* of the counterparty, the entire transaction in which these tranching instruments are used is to be treated as non-securitisation; if the credit risk *of an already existing payment obligation* is transferred through tranching instruments, the entire transaction in which these tranching instruments are used is to be treated as securitisation.

This assessment has to be made on a single-transaction basis. For example, assume Bank A and Bank B jointly provide financing to a project SPV through a senior loan (creditor: Bank A) and a junior loan (creditor: Bank B). As the tranching instruments (senior and junior loans) themselves generate the borrower's payment obligation, the entire transaction, and thus both the senior loan

and the junior loan, are treated as non-securitisation, i.e as SL or corporate exposures. If Bank A (senior loan creditor) were now to split the senior loan's credit risk by transferring it through tranching instruments (e.g. 'single CMBS'), this second transaction would be treated as a securitisation. If Bank A (the senior loan creditor and originator with respect to the securitisation transaction) uses the IRB approach for the senior loan borrowers, it would be able to estimate PD and LGD/CF (if authorised to use own-estimates of LGD/CF for that exposure class), or utilise the SL-simple risk weight, if applicable, for its exposure in the form of the senior loan. If Bank A retained any of the tranches created in the second transaction, it would have to calculate risk-weighted exposure amounts for these retained securitisation positions according to the securitisation framework, provided that it decided to take the second transaction into account as risk reducing for regulatory purposes, and provided further that the second transaction complied with the minimum criteria for effective and significant risk transfer for traditional or synthetic (as the case may be) securitisations.

Project Finance can include credit enhancements that in many cases can be considered to be tranching. The situation may be similar in Income-Producing Real Estate, where the transaction can be done via an SPV or a REIT-like structure. This raises the issue of whether all tranching transactions should be treated within the securitisation framework, or should some cases be treated under SL. The crucial difference between the two frameworks is that in SL, **the investor is expected to have a substantial degree of control over the physical collateral that constitutes the underlying asset**. This criterion is part of the SL definition (Article 86(6)(b) of the [Directive 2006/48/EC](#)), which states that one of the characteristics of SL exposures is that "the contractual arrangements give the lender a substantial degree of control over the assets and the income that they generate." This would not be the case in a securitisation.

- 5) **Whole loan transactions** are those where the credit risk of a single underlying risk exposure is transferred in tranches. Since the number of underlying exposures is not relevant in the securitisation definition, these transactions will be treated like any other securitisation. Similarly, **bilateral securitisations** (transactions that are not publicly issued to the market) will be also included in the securitisation framework.

## **ANNEX IV:**

### **Additional elaboration of the institution's internal documentation relating to the quantitative aspects of AMA**

- Assumptions implicit in the model.
- How the operational risk classes have been determined.
- How actual and constructed data are acquired and how they are used or incorporated in the model.
- The phases of input, execution, and output of the model.
- How internal holding periods are identified and how the 'regulatory holding period' is derived from them.
- How a soundness standard comparable to a 99.9 percent confidence level has been achieved.
- How expected and unexpected losses have been computed, and whether and how expected losses have been captured in internal business practices.
- The aggregation methodology used to compute the institution's overall operational risk estimate (or measure) from the individual operational risk estimates (or measures). In particular, the documentation should detail whether and how the correlations across the individual operational risk estimates have been computed and how they have been validated.
- Whether and how the impact of insurance has been recognised in the model.
- The process adopted to validate the model, especially: decision criteria and/or statistical tests for identifying situations where internal data are deemed sufficient/insufficient to compute operational risk measures.
- The policy for updating the model.

## **ANNEX VII**

### **Elements to be considered for model output**

The following is a non-exhaustive and non-binding list of elements that may represent good practice of the model output:

- If simulation methods (e.g. Monte Carlo) are used, an important variable is the number of steps to be performed. Good modelling practice suggests that the number should be consistent with the shape of the distributions and with the confidence level to be achieved. In particular, where the distribution of losses is heavy-tailed and a measure at a high confidence level is to be computed, the number of steps should be sufficiently large to reduce sampling variability to an acceptable level.
- If an Extreme Value Theory model is used, the number of data points above the threshold and the magnitude of the tail parameter usually drive the confidence level to which the operational risk measure can be computed. Institutions should pay particular attention to this area.
- The capital figure should be supplemented with appropriately computed confidence bands that identify the potential variability of the point estimate.
- Where the institution calculates both economic and regulatory operational risk capital, it should explain the reasons for any differences in the definitions, scope, methodologies, and results.

# Guidelines on Recognition of External Credit Assessment Institutions

## Guidelines on the recognition of External Credit Assessment Institutions<sup>77</sup>

### Executive Summary

1. The Capital Requirements Directive<sup>78</sup> (CRD) allows institutions to use external credit assessments to determine the risk weight of their exposures, provided the External Credit Assessment Institutions (ECAIs) that produce those assessments have been recognised as eligible for that purpose by the competent supervisory authorities. This recognition is granted only if the competent authorities judge an ECAI to meet the recognition criteria laid down in the CRD.
2. ECAI recognition for capital purposes does not in any way constitute a form of regulation of ECAIs or a form of licensing of rating agencies to do business in Europe. Its sole purpose is to provide a basis for capital requirement calculations in the Standardised Approach and the Securitisation Ratings Based Approaches.<sup>79</sup> These approaches are intended to increase the risk-sensitivity of capital requirements relative to the current framework, and to ensure that institutions using these approaches have appropriate levels of regulatory capital to support their aggregate credit risk.
3. This paper sets out CEBS' proposed common approach to the recognition of eligible ECAIs. This covers:
  - The recognition process,
  - The implementation of the CRD recognition criteria, and
  - The criteria for 'mapping' external credit assessments to the CRD risk weights.

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<sup>77</sup> As to the history of the guidelines on recognition of External Credit Assessment Institutions, please see the CEBS website where previously published: <http://www.c-eps.org/documents/Publications/Standards---Guidelines/files-from-old-website/GL07.aspx>

<sup>78</sup> Directives 2006/48/EC and 2006/49/EC.

<sup>79</sup> Recital 34(a) of the Directive 2006/48/EC states that "with regard to the use of both external and an institution's own estimates or internal ratings account must be taken of the fact that, at present, only the latter are drawn up by an entity - the financial institution itself - which is subject to a European authorisation process. In the case of external ratings use is made of the products of what are known as recognised ratings agencies, which in Europe are not currently subject to an authorisation process. In view of the importance of external ratings in connection with the calculation of capital requirements under this Directive, appropriate future authorisation and supervisory process for rating agencies need to be kept under review."

4. The guidelines detail the high degree of convergence that has been achieved among supervisors in recent months on both the procedural and substantive aspects of ECAI recognition. This includes a significantly enhanced common understanding of the recognition criteria set out in the CRD and of their implementation across the EU.
5. The intent of the guidelines is to provide the basis for consistent decision-making across jurisdictions, enhance the single-market level playing field, and reduce administrative burdens for all participants, including potentially eligible ECAs, institutions, and supervisory authorities.
6. The guidelines set out agreed procedures for the application and assessment process. Two modes of supervisory recognition are set out in the CRD: direct and indirect recognition. In direct recognition, supervisors make their own evaluation of an ECAI's compliance with the recognition criteria. In indirect recognition, supervisors recognise an ECAI based on recognition in another Member State, without carrying out their own evaluation process.
7. CEBS considers both of these approaches to be important and notes that indirect recognition can be a valuable instrument for enhancing efficiency and reducing administrative burdens. CEBS believes that the common understanding set out in the guidelines will provide a sound foundation for supervisors' use of the indirect recognition approach in relevant circumstances.
8. Where recognition is sought in more than one Member State, competent authorities will cooperate in a joint assessment process. The aim of the joint assessment process is to reach a shared view on compliance with the recognition criteria, while respecting the requirements of the CRD for individual decisions by supervisors.
9. Supervisors propose to carry out an overall assessment of ECAs' eligibility according to the CRD recognition criteria, based on the common understanding set out in this paper and using information identified in a 'common basis application pack.'
10. Concerning the 'mapping' of external credit assessments to the CRD's credit quality steps, CEBS considers the Basel Committee's guidance for supervisors, set out in Annex 2 of the [Basel II framework published in June 2004](#), to be valuable and appropriate, and recommends that supervisors follow it. A common approach to mapping is important for ensuring consistency across the EU and reducing the risk of regulatory arbitrage.
11. In developing its guidelines, CEBS has benefited from on-going dialogue and meetings with a large number of market participants. The guidelines went through a three-month public consultation in 2005. Special attention was given to the technical issue of the mapping of securitisation positions and collective investment undertakings (CIUs), which went through a dedicated one-month public consultation.

12. The comments received have been published on the CEBS website unless the respondents requested otherwise. Feedback on the responses received has been published in a separate document (see [http://www.c-eps.org/documents/Publications/Consultation-papers/2005/CP07/CP07\\_feedback.aspx](http://www.c-eps.org/documents/Publications/Consultation-papers/2005/CP07/CP07_feedback.aspx) ).
13. CEBS participated as an observer to the Committee of European Securities regulators (CESR) task force on Credit Rating Agencies, which drafted technical advice to the European Commission on possible measures concerning credit rating agencies in March 2005. The dialogue between the two Committees has continued since then, in order to ensure complementary approaches.
14. In view of the approaching deadline for implementation, it is desirable that the recognition of ECAIs should advance as quickly as possible. While formal processes cannot begin before finalisation and transposition of the CRD, many supervisors intend to be in a position to accept informal applications in the near future. Those supervisors are expecting to start this process on the basis of these guidelines from the beginning of February 2006.

## Introduction

15. An eligible ECAI is an entity, other than an Export Credit Agency<sup>80</sup>, that issues external credit assessments, and that has been determined by the competent authorities to meet the eligibility requirements set out in the Capital Requirements Directive<sup>81</sup> (CRD). Only the credit assessments of an eligible ECAI, and for some exposures, the credit assessments of Export Credit Agencies, may be used by credit institutions and investment firms<sup>82</sup> (institutions) for the purposes of determining risk weights under the Standardised Approach and the Securitisation Ratings Based Approaches.
16. The CRD allows Member States to recognise an ECAI as eligible in two ways: direct recognition, in which the competent authority carries out its own assessment of the ECAI's compliance with the CRD's eligibility criteria; and indirect recognition, in which the competent authority recognises the ECAI without carrying out its own evaluation, relying instead on the recognition of the ECAI by the competent authority of another Member State.
17. A common understanding of the recognition criteria and processes has been developed to support consistency in direct recognition

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<sup>80</sup> Annex VI, Part 1, paragraph 7 of the Directive 2006/48/EC states the criteria that a credit assessment of an Export Credit Agency must meet in order to be recognised for determining the risk weighting of exposures to central governments and central banks. See Part 4 of this paper.

<sup>81</sup> The CEBS Guidelines are based on the Capital Requirements Directive, which replaced the existing Consolidated Banking Directive (2000/12/EC) and Capital Adequacy Directive (93/6/EEC).

<sup>82</sup> See Article 2(2)(a) of the Directive 2006/48/EC.

decision-making across the EU and to increase the scope for indirect recognition. In order to avoid the inefficiencies of sequential direct recognition processes in cases where applications for the same ECAI are received by a number of competent authorities, those competent authorities will participate in a 'joint assessment process' to assess together the ECAs' eligibility. Recognising that the CRD requires a decision by each competent authority, where a shared view is achieved, this should form the basis for national decision-making.

- 18 By adopting common procedures and reaching a common understanding of the CRD recognition criteria, competent authorities seek to ensure the consistency of the recognition process. In particular:
- All ECAI applications will have to be supported by evidence that the credit assessments will be used for regulatory capital purposes under the Standardised and/or Securitisation Ratings Based Approaches.
  - The applicant will have to fill out an application pack. CEBS has developed a 'common basis application pack' which will provide supervisors with an adequate level and amount of information for their assessment. Competent authorities will be able to collect additional information needed to address country-specific issues.
  - Supervisors will assess the information provided in the application pack in accordance with the common understanding of the CRD recognition criteria laid out in this paper. The purpose of the recognition criteria is to identify ECAs that produce external credit assessments of sufficiently high quality, consistency and robustness to be used by institutions for regulatory capital purposes under the Standardised Approach and the Securitisation Ratings Based Approaches.
- 19 To ensure the transparency of the recognition process, supervisors are required to disclose an explanation of their recognition process and a list of eligible ECAs. These disclosures will be part of the CEBS supervisory disclosure framework, which has been designed to allow for a meaningful comparison<sup>83</sup> of the disclosed information.
- 20 To calculate the risk weight of exposures under the Standardised Approach and the Securitisation Ratings Based Approach, competent authorities have to determine which credit quality steps the external credit assessments are to be associated with. Those determinations shall be objective and consistent, and based on both qualitative and quantitative factors.

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<sup>83</sup> See Article 144 of the Directive 2006/48/EC

- 21 In general terms, and consistent with the CRD (which requires the use of a benchmark), the approach to mapping set out in the guidance provided by the Basel Committee (Basel II framework, June 2004, Annex 2) is considered to represent the appropriate basis for mapping under these guidelines. It incorporates the use of three-year cumulative default rates together with qualitative analysis and appropriate flexibility of supervisory response.
- 22 The CRD requires supervisors to carry out a separate mapping of securitisation positions, using both quantitative and qualitative factors. Supervisors will consider quantitative factors such as default and loss rates, and qualitative factors such as the methodologies adopted by ECAIs, the range of transactions assessed, and whether market participants view ECAIs' ratings of securitisation products as being equivalent.
- 23 The guidelines adopt a tailored approach to the spirit and use of the credit assessments of Collective Investment Undertakings (CIUs) in the Standardised and Securitisation Ratings Based Approaches, in order to capture the variety of funds in the market. The guidelines state that, to be eligible, a CIU credit assessment must depend primarily on the credit quality of the underlying assets. CIU credit assessments will not be subject to a separate mapping approach, but will be mapped using the approach referred to in paragraph 7 above.
- 24 This paper has four parts and an annex:
- Part 1 describes the process for applying for ECAI recognition and outlines how applications will be handled by competent authorities.
  - Part 2 sets out CEBS' common understanding on interpretation and application of the CRD criteria for assessing whether an ECAI is eligible for the purposes of the CRD.
  - Part 3 proposes guidance to competent authorities for mapping the credit assessments of eligible ECAIs to the credit quality steps in the CRD. This section addresses specific issues relating to the mapping of particular portfolios, such as short-term credit assessments and the credit assessments of securitisation positions and CIUs.
  - Part 4 provides clarification on the use of Export Credit Agencies' assessments for regulatory capital purposes in accordance with the provisions of the CRD.
  - Annex I lists the information requirements that form the 'common basis application pack' to be used by supervisors.

## **Part 1: The recognition process**

### **General principles**

- 25 The responsibility for assessing whether the CRD recognition criteria are fulfilled and an ECAI should be recognised as eligible lies with the competent authority of the country where the institution that intends to use that ECAI's credit assessment is authorised and supervised.
- 26 Recognition of an ECAI by a competent authority should not be taken as indicating suitability for any purpose other than the calculation of regulatory capital requirements using the Standardised Approach or the Securitisation Ratings Based Approach. Institutions retain full responsibility for their internal risk management.
- 27 The recognition process is initiated when the competent authority receives an application for recognition. The competent authority in each Member State will indicate and disclose from which type of entity it will accept applications: ECAIs and/or institutions that intend to use the ECAI's credit assessments for risk weighting purposes. Further details are provided below.
- 28 In any event, before undertaking an assessment of an ECAI's eligibility, the competent authority will have to determine that at least one institution within its jurisdiction intends to use the ECAI's credit assessments for risk-weighting purposes. This will ensure that competent authorities need only consider applications of ECAIs whose credit assessments would actually be used under the Standardised or the Securitisation Ratings Based Approaches.
- 29 An institution will not be allowed to apply on behalf of, or to nominate for its own capital purposes, an ECAI which is its subsidiary. This prohibition is judged necessary for consistency with the policy of avoiding any institution using 'external' credit assessments which are issued within its group.
- 30 Competent authorities must be provided with all material information they need in order to assess whether an ECAI meets the CRD eligibility criteria. Consequently, regardless of how an application is initiated, the recognition process will require the full cooperation of the ECAI, in terms of its willingness and promptness in providing necessary information.
- 31 Some ECAIs may apply for recognition in more than one Member State, or equivalently, institutions in more than one Member State may submit an application on behalf of the same ECAI. Competent authorities will adopt a single joint approach to the assessment of such applications. This approach has been designed to avoid duplication of work, promote supervisory efficiency, and reduce the overall burden of the recognition process. The aim is to reach a shared view on the ECAI's eligibility and on the mapping of its credit assessments to the CRD's credit quality steps. Each national

competent authority will then take its own decision on the basis of the joint assessment and any other information it deems relevant.

- 32 If additional competent authorities receive applications concerning the ECAI at a later date, they can choose whether to recognise indirectly the decisions already made by other competent authorities or to undertake their own direct assessment of the ECAI.
- 33 Both of these approaches are considered to be important. Indirect recognition can be a valuable instrument for enhancing efficiency and reducing administrative burdens. The common understanding below should provide a robust foundation for the use of the indirect recognition approach by competent authorities in appropriate circumstances.
- 34 Each competent authority shall disclose an explanation of its recognition process and a list of eligible ECAIs. This information should be included in the information disclosed in the common supervisory disclosure framework set out by CEBS<sup>84</sup> : <http://www.c-ebs.org/Supervisory-Disclosure/Rules-and-guidance.aspx> .

### **Application**

- 35 The recognition process is initiated when the competent authority receives an application for recognition. In order to provide the flexibility required by different national circumstances, each competent authority can decide whether to adopt an application process in which the applicants are ECAIs, a process in which the applicants are institutions that intend to use the ECAI's credit assessments for risk-weighting purposes, or a process in which the applicant can be either one.<sup>85</sup> Each competent authority shall disclose which application process applies within its jurisdiction. This information should also be included in the information disclosed in the common supervisory disclosure framework set out by CEBS.
- 36 When the applicant is an ECAI, it should demonstrate that at least one institution in the competent authority's jurisdiction intends to use its credit assessments for prudential risk-weighting purposes. This could be achieved by including in the application the name of at least one institution that proposes or intends to use the ECAI's credit assessments for capital purposes.
- 37 As explained in paragraphs 99 to 101 below, an ECAI's application will be assessed separately for recognition in each of three main market segments: public finance, commercial entities (including

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<sup>84</sup> CEBS guidelines on a common European supervisory disclosure framework. More information can be found on the CEBS website: <http://www.c-ebs.org>

<sup>85</sup> Depending on the national legal setting, some competent authorities may wish to ask institutions to channel their applications through their national banking association.

corporates and financial companies), and structured finance (including securitisation). Applications shall indicate in which market segment recognition is being sought, and whether recognition is sought for use of credit assessment for the risk weighting of securitisation positions.

- 38 In cases where recognition is being sought in more than one Member State, it will be important for competent authorities to be made aware of all jurisdictions in which recognition is being sought, so that appropriate cooperation arrangements between competent authorities can be organised (see paragraphs 47 to 63 below).
- 39 All applications should be supported by comprehensive, transparent, and appropriately concise documentation, as indicated below. When applications are initiated by institutions that intend to use an ECAI's credit assessments, it will be highly desirable for the ECAIs to ensure that all the relevant and material information deemed necessary for the sole purpose of ECAI recognition has been delivered to the competent authorities.

### **The level of recognition**

- 40 Some ECAIs have subsidiaries in different Member States. The CRD does not specify the level at which the ECAI recognition process should apply: at the group level or at the subsidiary level.
- 41 A central question in deciding whether to give recognition at the level of the group or at the subsidiary level will be whether a given credit assessment grade is judged to represent the same opinion as to the creditworthiness of a given rated entity, regardless of the geographical location where the credit assessment has been issued.
- 42 If an ECAI group can demonstrate that each of the subsidiaries for which it seeks recognition adheres to practices and procedures that are set at a group-wide level, then it will not be required to make separate applications for each subsidiary. However, separate applications will be required if subsidiaries use credit assessment practices, methodologies, and procedures that are materially different from those of the group.
- 43 This approach recognises the organisation of certain cross-border ECAIs, which apply the same 'core' credit assessment methodology consistently throughout the group. This organisation is considered to ensure the comparability of credit assessments undertaken in different countries, regardless of the legal structure of the ECAI group and notwithstanding the fact that the process of assigning credit assessments may involve credit analysts and rating committees located in a wide range of geographical locations.
- 44 However, 'group-level' applications shall not include 'affiliates' or joint ventures. Even if they use the same methodologies or comply with the same Code of Conduct as the group they are associated with, some of their characteristics may differ from those of the group under consideration. For instance, their ownership structure may differ from that of the ECAI group. Competent authorities will

therefore need to assess those 'affiliates' or joint ventures separately.

### **The form of recognition**

- 45 The CRD allows Member States to recognise ECAIs as eligible in two ways: direct recognition, in which the competent authority carries out its own assessment of the ECAI's compliance with the CRD eligibility criteria; and indirect recognition, in which the competent authority recognises the ECAI without carrying out its own direct recognition process<sup>86</sup>, relying instead on the recognition of the ECAI by the competent authority of another Member State. Member States may use a combination of the two approaches.
- 46 The CRD does not provide for Member States to recognise an ECAI on the basis of recognition by the competent authorities in a non-EU country. Therefore, in order to be eligible within Europe, ECAIs will have to be recognised by the competent authority of at least one Member State.

### **Application in more than one Member State**

- 47 As mentioned in paragraph 31 above, some ECAIs may apply for recognition in more than one Member State, or, equivalently, institutions in more than one Member State may submit an application on behalf of the same ECAI. This is likely to occur when the ECAI provides credit assessment services in several Member States, but it may also occur when an ECAI assesses the credit quality of issuers located in only one Member State and those assessments are used by institutions in other Member States.
- 48 General legal considerations dictate that a separate application for ECAI recognition must be made in each Member State in which a credit institution intends to use the ECAI's credit assessments for prudential risk-weighting purposes, and that each national competent authority must make its own decision on the ECAI's eligibility.
- 49 In order to make the recognition process as efficient as possible in such cases, CEBS recommends that competent authorities seek the greatest possible convergence in approach, both by seeking a consensus on minimum eligibility criteria (this being the goal of the present document), and by cooperating closely in the joint assessment process.
- 50 Consistency in national supervisory approaches to ECAI recognition has the advantages of:
- a. Avoiding unnecessary duplication of effort on the part of competent authorities, and
  - b. Reducing the compliance burden for applicants.

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<sup>86</sup> i.e. without conducting its own assessment of the ECAI's compliance with the eligibility criteria of the CRD.

- 51 In order to facilitate a fully inclusive and coordinated approach, each competent authority must be aware of all other competent authorities that will be assessing the eligibility of the same ECAI.
- a. When applications are initiated by an ECAI, the ECAI's application should include a list of any other Member States in which it is seeking or plans to seek recognition in the future.
  - b. When applications are initiated by institutions, competent authorities will take the necessary steps to ascertain which other competent authorities have received applications for the same ECAI, and to ensure that all of them are aware that a coordinated approach is being initiated.
  - c. In either case, the CEBS Secretariat could provide logistical support for the joint process if necessary.
- 52 Within a month of receiving such an application, all the competent authorities concerned will meet to determine a single joint process for reviewing the applications.
- 53 The actual arrangements decided upon will vary on a case-by-case basis. In some cases – for example, when an ECAI operates predominantly in a single Member State - it may be appropriate for the assessment to be undertaken by a single competent authority. In other cases, it may be appropriate for a subset of interested competent authorities to undertake a joint assessment, with other competent authorities choosing – on a voluntary basis – not to participate directly. In yet other cases, all the competent authorities concerned may wish to be involved in a single joint process.
- 54 In any case, for the sake of efficiency, a 'process facilitator' will be appointed who will carry out the tasks of coordinating and ultimately producing the joint assessment. The ECAI concerned will be informed of the type of recognition process to be undertaken and of the identity of the process facilitator.
- 55 The authorities involved will agree among themselves on the process facilitator. For this purpose, the following non-exhaustive set of criteria may be used:
- The extent to which an ECAI is focused on or will be used in a particular territory or territories.
  - The relationship between the supervisor and the ECAI. Some ECAs may maintain regular contacts via business-related issues and events.
  - Administrative convenience, burden optimisation, and an appropriate distribution of tasks.
- 56 The role of the process facilitator consists of coordinating and ultimately producing the joint assessment report. It includes:
- Ensuring that all the information necessary to carry out the joint process is shared among the members,
  - Ensuring that a precise timetable and workplan are established for carrying out the joint assessment within a

reasonable timeframe. This should include facilitating agreement on the division/allocation of tasks amongst participants,

- Acting as the point of contact for the interested parties – including ECAIs, institutions and other competent authorities – collecting and disseminating information as required,
- Facilitating agreement on requests for further information,
- Ensuring that supervisors adhere to the agreed working plan and ensure the timely delivery of the report, and
- Ensuring that the report is produced and made available to all interested competent authorities. (see paragraphs 61 to 63 below).

- 57 The aim of the joint process is to reach a shared view on the ECAI's eligibility and on the mapping of its credit assessments to the CRD's credit quality steps. This shared view will be the outcome of a joint assessment of the ECAI's methodology and its credit assessments.
- 58 Each competent authority will then take its own decision as to whether to recognise the ECAI, on the basis of the joint assessment and any other information it deems relevant.
- 59 Participation in the joint assessment does not preclude a national competent authority from undertaking any additional assessment it deems appropriate. In particular, competent authorities may judge that an ECAI's organisation or credit assessment methodology raises country-specific issues that are not fully captured by the broader consideration of the ECAI's eligibility at a group level during the joint assessment. Competent authorities may wish to take such national specificities into account in coming to their own eligibility decisions.
- 60 The joint assessment will be made on the basis of the ECAI's answers to the 'common basis application pack' outlined in Annex I of this paper, any additional supporting information provided by the applicant, and any other information requested by the process facilitator. The joint assessment will also be based on the guidelines on recognition criteria issued by CEBS.
- 61 Once the joint assessment of an ECAI has been completed, it will be made available to all competent authorities that have received applications for recognition of that ECAI, or where the ECAI has indicated that it intends to make an application.
- 62 The joint assessment report will be provided upon request to the competent authorities that did not receive an application.<sup>87</sup> In view of the confidentiality of the supporting documentation of the application pack provided by the ECAIs and upon which the report has been drafted, this will be subject to the prior consent of the ECAI.

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<sup>87</sup> The CRD does not require competent authorities using indirect recognition to conduct their own assessment.

- 63 The joint assessment report itself will be communicated to the ECAI with the agreement of all the supervisors involved in the joint process. The way in which the ultimate decision of a competent authority is communicated to the applicant will be determined in accordance with the national legal setting.

### **Provision of information to support the application**

- 64 It is important that the minimum information to be provided by applicants is commonly agreed, in order to reduce inconsistent information requirements by individual competent authorities.
- 65 The adoption of similar information requirements will also facilitate cooperation between competent authorities and encourage greater use of indirect recognition, since competent authorities will be more inclined to rely on each other if they have some comfort that decisions are based on similar procedures and types of input.
- 66 Without prejudice to domestic language requirements, in order to facilitate the joint recognition process, documentation should be provided in a language of mutual understanding. The language will be determined on a case-by-case basis.
- 67 Competent authorities should be guided by two principles in determining how much and what level of information to request from ECAIs. On the one hand, they should obtain sufficient information to be able to make a well-informed decision as to whether an ECAI satisfies the CRD's recognition criteria. On the other hand, they should request only that information they need to exercise their responsibilities under the CRD, i.e. only that information that is necessary to assess an ECAI's eligibility for prudential capital purposes.
- 68 In order to balance these twin objectives, CEBS has developed the 'common basis application pack' set forth in Annex 1 to this paper. CEBS proposes that competent authorities use this pack as the basis for their requests for information from ECAIs. If necessary, competent authorities can ask for complementary information and documentation on a case-by-case basis, to be discussed, if needed, in additional contacts with the ECAI.
- 69 The joint assessment will be based on the documentation provided by the applicant in the application pack. All communication with the ECAI concerning the joint assessment, including any request for additional information deemed necessary for it, will be made by the process facilitator to the ECAI on behalf of the competent authorities involved.
- 70 The use of the common basis application pack during the joint assessment process does not preclude the competent authorities from asking for the information necessary to address any country-specific issues they have identified, before they take their decision.

- 71 The application pack permits competent authorities to consider the granularity<sup>88</sup> of the ECAI's methodology, on both an asset class and market segment and geographical basis. For cross-border ECAIs, such information will be used to assess the extent to which separate recognition processes are needed for specific asset classes or geographical locations.
- 72 CEBS believes that much of the information called for in the application pack will already be available in ECAIs' existing documentation, and that they should therefore be able to provide concise answers. However, some additional information may be needed, in particular concerning default data and other quantitative tools on which ECAIs base their opinion of the creditworthiness of an entity.

### **Review of application by the competent authority**

- 73 Competent authorities shall base their recognition decisions on an assessment of the objectivity, independence, on-going review, and transparency of the ECAIs' methodologies and the credibility and transparency of their credit assessments.
- 74 CEBS has developed a set of guidelines for meeting these criteria, to be followed by all competent authorities. These guidelines are set out in Part 2 of this paper.

### **Disclosure by the competent authority**

- 75 Article 81(4) of the [Directive 2006/48/EC](#) requires competent authorities to make publicly available an explanation of the recognition process and a list of eligible ECAIs.
- 76 In line with the CEBS supervisory disclosure framework mentioned in paragraph 34 above, this disclosure should include the name of each eligible ECAI along with the mapping that the competent authority has established between the ECAI's credit assessments and the 'credit quality steps' set out in the CRD. The disclosure should also include information on how the recognition process has been initiated, whether a joint process has been carried out, the market segments for which recognition has been sought, and the mapping used. The disclosures should be kept updated.

### **On-going review of eligibility**

- 77 To ensure that the credit assessments used by institutions in calculating their capital requirements remain of sufficiently high quality, competent authorities will need to assess whether ECAIs to which they have granted recognition continue to meet the eligibility criteria of the CRD on an ongoing basis.

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<sup>88</sup> ECAIs generally use different rating methodologies for exposures in different asset classes and/or different geographical regions. 'Granularity' refers to the fineness of these divisions. For example, using a distinct methodology for French residential mortgage-backed securities is more granular than using one methodology for all European structured finance.

- 78 As with initial assessments, ongoing assessments should be tailored to the purposes of the CRD and should be limited to ensuring that eligible ECAIs continue to meet the criteria that led to their initial recognition.
- 79 Specifically, competent authorities shall monitor the effects of any material changes that ECAIs have reported to them in accordance with Annex VI, Part 2, paragraph 6 of the Directive 2006/48/EC and as spelled out in paragraph 121 below.
- 80 In addition, competent authorities will undertake an analysis in an appropriate depth of each ECAI's eligibility every five years.
- 81 Competent authorities which have been directly involved in an initial joint recognition process will cooperate and jointly carry out the on-going review. A process facilitator shall act as a contact point with the ECAI and facilitate coordination among the relevant competent authorities.
- 82 In cases where the ECAI has been directly recognised by additional competent authorities at a later date (see paragraph 18 above), these competent authorities will be invited to participate in the joint review.
- 83 Competent authorities shall withdraw the recognition of any eligible ECAI that ceases to comply with the CRD recognition criteria, after first discussing the matter with the ECAI. Any withdrawal will be communicated to the other competent authorities.

## **Part 2: Common understanding of the ECAI recognition criteria laid down in the CRD**

### **General principles**

- 84 The key purpose of the recognition criteria is to identify ECAIs that produce external credit assessments of sufficiently high quality, consistency and robustness to be used by institutions for regulatory capital purposes under the Standardised Approach and the Securitisation Ratings Based Approaches.
- 85 For this purpose, competent authorities will investigate whether the ECAI has processes and procedures in place which ensure that credit assessments meet the standards stated above.
- 86 In determining which ECAIs are eligible for the Standardised Approach, competent authorities shall take into account the technical criteria set out in Annex VI, Part 2 of the [Directive 2006/48/EC](#).<sup>89</sup>

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<sup>89</sup> Article 81(2): "competent authorities shall recognise an ECAI as eligible for the purposes of Article 82 only if they are satisfied that its assessment methodology complies with the requirements of objectivity, independence, ongoing review and transparency, and that the resulting credit assessments meet the requirements of credibility and transparency. For those purposes, the competent authorities shall take into account the technical criteria set out in Annex VI, Part 2."

- 87 Moreover, according to Article 97(2) of the Directive 2006/48/EC, competent authorities shall recognise an ECAI as eligible for the purposes of Article 96 –calculation of the risk-weighted amount of a securitisation position - only if they are satisfied that it has complied with the requirements laid down in Article 81, taking into account the technical criteria in Annex VI, Part 2, and that it has demonstrated ability in the area of securitisation which may be evidenced by a strong market acceptance. In addition, the credit assessments shall comply with the principles of credibility and transparency as elaborated in Annex IX, Part 3.
- 88 Competent authorities must treat all ECAIs equally. However, given the different business models adopted by individual ECAIs, competent authorities may need to take a differentiated approach to assessing how they satisfy the CRD recognition criteria. Accordingly, they may place different weights on the various criteria for different ECAIs – subject of course to their all satisfying these CRD criteria – if this serves the ultimate objective of establishing whether an ECAI's methodology and credit assessments are suitable for calculating regulatory capital requirements.
- 89 In coming to an assessment, competent authorities will take into consideration the ability of the ECAI to produce robust credit assessments, based on quantitative methods and a proven data track record.
- 90 Competent authorities will also take account of market indications of the ECAI's standing. For example, strong market acceptance and the existence of a long track record may be viewed as indications that the market has a favourable opinion of the ECAI's methodology and credit assessments. As indicated in paragraphs 126 to 130, the relevant threshold for eligibility is that the assessments are recognised as credible and reliable by market users. Stronger market acceptance is not a prerequisite, but rather a factor which is relevant in determining the intensity of assessment of other factors.
- 91 In addition, the extent to which an ECAI adheres to a code of conduct which is in line with market standards and internationally recognised principles such as the IOSCO Code of Conduct Fundamentals for Credit Rating Agencies - and the public disclosure of such a code - may contribute to satisfying competent authorities that the ECAI conforms to certain CRD criteria, such as the independence criterion. This could reduce the amount of analysis that the competent authorities themselves need to undertake in order to verify the ECAI's eligibility in these areas.
- 92 The implementation of a recognition regime may be perceived as creating barriers to entry in the market for external credit assessments. While seeking to avoid any unnecessary interference with the market, competent authorities recognise that their primary objective is the prudential need to identify which ECAIs are eligible for risk weighting purposes.

## The technical criteria<sup>90</sup>

### 1. Methodology

#### 1.1. Objectivity

Competent authorities shall verify that the methodology for assigning credit assessments is rigorous, systematic, continuous, and subject to validation based on historical experience.

- 93 The purpose of this criterion is to ensure that an ECAI's credit assessment methodology produces an informed and well-founded opinion on the creditworthiness of the rated entities, and that its credit assessments are based on all information deemed relevant and available at the time they are issued.
- 94 In meeting this criterion, an ECAI will need to demonstrate that its methodology incorporates factors known to be relevant in determining an entity's creditworthiness. This demonstration should, to the fullest extent possible, be supported by statistical evidence that the methodology has produced accurate credit assessments in the past.
- 95 The ECAI must also implement and follow procedures which ensure that its pre-defined credit assessment methodology is applied consistently in the formulation of all credit assessments in a given asset class, such that two identical companies would receive equivalent credit assessments, and different analysts or rating committees within the ECAI would assign equivalent credit assessment to any given entity.
- 96 Preliminary discussions with some ECAIs indicate that they do not have a single credit assessment methodology. This is to some extent evidenced by their publication of numerous papers describing their credit assessment methods for different asset classes (e.g. corporates versus institutions), for different sub-classes (e.g. automobile manufacturers versus oil companies) and for different geographical regions (e.g. European auto manufacturers versus US auto manufacturers).
- 97 However, ECAIs appear to apply a similar 'core' credit assessment methodology within broad asset classes or market segments. The same factors are identified as significant in determining a credit assessment for all entities within the broad asset class, although different emphasis may be put on the importance of individual factors when assessing different companies within that broad asset class.
- 98 In defining broad asset classes and/or market segments, it is not necessary for the core assessment factors to be evaluated in an identical and mechanical way for all entities within a group. Indeed,

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<sup>90</sup> The boxed text represents the technical criteria set out in Annexes VI and IX of the Directive 2006/48/EC. When there are differences between the two Annexes, they are explicitly mentioned.

it is expected that an ECAI will place different emphasis on the importance of individual factors when assessing different companies and/or markets, and will take such differences into account. What is important is that the same core factors are always considered, to some extent, when assessing an entity within the given asset class and/or market segments.

- 99 With regard to the definition of these broad groups, it appears that ECAIs generally use similar credit assessment methodologies within each of the following three broad asset classes or market segments: structured finance, public finance, and commercial entities (including corporates and financial companies).
- 100 CEBS proposes that such broad asset classes or market segments form the basis of the ECAI recognition process with separate assessment of the ECAI's methodology by competent authorities in each of the broad asset classes. This is not intended to prevent ECAIs from seeking recognition for a methodology which is more specifically focused, e.g. on SMEs.
- 101 When assessing an ECAI's methodology in any of these broad asset classes or market segments, competent authorities will avoid making a direct judgment as to whether an ECAI's methodology is objectively correct. They should not be seen as endorsing any particular type of methodology.
- 102 Instead, competent authorities should concentrate on assessing whether the credit assessment processes adopted by an ECAI produce credit assessments that embody a sufficient level of consistency and discrimination to provide the basis for capital requirements under the Standardised and Securitisation Ratings Based Approaches.
- 103 This assessment should focus on three factors:
- a. Quantitative evidence of the discriminatory power of the ECAI's credit assessment methodology, using statistical techniques such as default studies and transition matrices to demonstrate the robustness and predictive power of credit assessments over time and across different asset classes;
  - b. The ECAI's demonstration that it has processes in place to assess factors driving creditworthiness and to ensure that these factors are incorporated into the credit assessment methodology; and
  - c. The ECAI's demonstration that it has procedures which ensure that its predefined methodology is applied consistently in the formulation of all credit assessments.
- 104 Where appropriate, competent authorities should use quantitative evidence of the consistency and predictive power of an ECAI's credit assessments (the outputs of their methodological process) as an indicator of the objectivity of its methodological processes (the inputs of the methodological process). When ECAIs have a demonstrable track record of producing robust credit assessments (outputs) using quantitative methods such as default or transition

studies, competent authorities should view this as a good indication that its methodological processes (inputs) are sufficiently objective for the purposes of the CRD. This may reduce the level of assessment that competent authorities themselves have to undertake.

- 105 In cases where there is less quantitative evidence to support the robustness of an ECAI's credit assessments (outputs), competent authorities will need to undertake a greater assessment of the ECAI's methodological process (inputs) in order to be satisfied that the ECAI's methodology meets the objectivity criterion.
- 106 As indicated above, the assessment of the ECAI's methodology should remain high-level. Competent authorities should not undertake a detailed assessment of the exact methodology used by the ECAI, but should instead satisfy themselves that the credit assessment drivers used in the ECAI's methodology are sensible predictors of creditworthiness, and that the ECAI's internal procedures ensure that its pre-defined credit assessment methodology is applied consistently in the formulation of all credit assessments within each broad asset class or market segment.
- 107 The CRD requires competent authorities to verify that ECAs validate their methodologies based on historical experience. As indicated above, quantitative validation will need to be based on the ECAI's credit assessments (the outputs of the methodology) rather than on the methodology itself. ECAs should demonstrate that the methods they use in their quantitative assessment confirm the robustness, discriminatory power, and consistency of their credit assessments over time and across different market segments. In addition, ECAs should demonstrate that procedures are in place to ensure that systematic rating errors highlighted by back-testing will be incorporated into credit assessment methodologies and corrected.

## 1.2. Independence

Competent authorities shall verify that the methodology is free from external political influences or constraints, and from economic pressures that may influence the credit assessment.

Independence of the ECAI's methodology shall be assessed by competent authorities according to factors such as the following:

- (a) ownership and organisation structure of the ECAI
- (b) financial resources of the ECAI
- (c) staffing and expertise of the ECAI
- (d) corporate governance of the ECAI

- 108 This criterion is intended to ensure that all credit assessments issued by ECAs are independent and objective in all circumstances, including when conflicts of interest may arise.

- 109 Conflicts of interest may arise as a result of external political or economic pressures. Examples include the following situations:
- The ECAI is owned by a government, trade association, or political body that has an interest in securing favourable credit assessments for its constituent entities.
  - The ECAI is owned by a private company which could use its position to secure favourable credit assessments.
  - The ECAI's financial position depends on revenue from key customers who could seek to leverage their position to secure favourable credit assessments.
  - The ECAI provides ancillary services to rated entities or has other business relationships with them that could undermine the objectivity of its credit assessments.
  - An ECAI employee is in a managing position in a rated entity.
  - The ECAI's staff is compensated in a way, or they have business relationships with the rated entities, that could lead to non-objective credit assessments.
- 110 An institution will not be allowed to nominate for its own capital purposes an ECAI which is its subsidiary.
- 111 Competent authorities must be comfortable that ECAIs have procedures in place to ensure that their methodologies are free from political influences or constraints and from economic pressures that may influence the credit assessments. In order to satisfy competent authorities on this point, ECAIs will need to demonstrate:
- a. That they have adopted, monitored, and successfully applied internal procedures to ensure that all credit assessments are formulated in a consistent and objective manner, particularly in situations where conflicts of interest may arise and could threaten objectivity;
  - b. That they have mechanisms in place to identify actual and potential conflicts of interest and take reasonable measures to prevent, manage and eliminate them, so that they do not impair the production of independent, objective, and high-quality credit assessments.
- 112 CEBS considers that ECAIs themselves are in the best position to design internal procedures, fee policies, staff management practices, corporate governance rules, and internal codes of conduct that manage potential conflicts of interests and ensure that their credit assessment methodologies are free from political and economic influences. It should be demonstrated that ECAIs have adopted appropriate internal practices and procedures in this respect, and in particular in the following areas:
- a. It should be demonstrated that ECAIs have put in place, and apply, adequate safeguards to ensure their independence from ownership, and to prevent external pressure or constraints –

either political or economic – from jeopardising the objectivity of the credit assessment process.

- b. It should be demonstrated that ECAI's organisational structure separates its credit assessment business – operationally, personally and potentially legally – from any other business, such as consulting services, that undermine the objectivity of the credit assessments.
- c. With regard to financial resources, it should be demonstrated that ECAs are sufficiently robust and have adequate safeguards in place to ensure independence from key customers and issuers, and prevent non-objective credit assessments.
- d. In terms of staffing and expertise, it should be demonstrated and self-certified that ECAI's staff has the levels of skills and experience necessary to perform the tasks required of them - for example, that at least one person involved in the rating decision-making process has at least three years experience as a rating analyst or in a comparable function (e.g. as an analyst in a credit institution). The ECAI should also have enough resources to carry out consistent assessments and to have frequent contacts with the rated companies when this represents a necessary part of their methodology.
- e. ECAs should have an independent internal audit function. Those that do not (e.g. non-publicly listed entities) should have a function that plays the same role and carries out the same tasks.
- f. The integrity of the credit assessment process should be ensured by adequate written internal procedures, corporate governance rules, fee policies, and, where relevant, an internal code of conduct.
- g. In order to promote independence through transparency and market scrutiny, ECAs should consider disclosing situations where conflicts of interest have arisen or may potentially arise, and the mechanisms in place to identify, prevent, manage, and eliminate conflicts of interest.

### **1.3. On-going Review**

Competent authorities shall verify that ECAI's credit assessments are subject to ongoing review and shall be responsive to changes in the financial conditions. Such review shall take place after all significant events and at least annually.

Before any recognition, competent authorities shall verify that the assessment methodology for each market segment is established according to standards such as the following:

- (a) The backtesting must be established for at least one year.

(b) The regularity of the review process by the ECAI must be monitored by the competent authorities.

(c) The competent authorities must be able to receive from the ECAI the extent of its contact with the senior management of the entities which it rates.

Competent authorities shall take the necessary measures to be promptly informed by ECAIs of any material changes in the methodology they use for assigning credit assessments.

- 113 The purpose of the ongoing review criterion is to ensure that the ECAI's external credit assessments remain appropriate over different periods of time and through changes in market conditions.
- 114 The CRD does not define the terms 'changes in financial conditions' or 'significant events.' However, these terms are linked; both refer to any event (financial or otherwise) that is large enough to potentially or actually change the credit assessment assigned by an ECAI to an entity.
- 115 Competent authorities will not themselves undertake any on-going review of the credit assessments of the ECAI. They will instead verify that ECAIs have procedures in place to ensure that their credit assessments remain appropriate over different time periods and market conditions. In particular, competent authorities will require ECAIs to demonstrate that they have processes in place that:
- a. Reliably detect changes in conditions facing a rated entity that are large enough to potentially change its assignment to a credit assessment category, and
  - b. Ensure that a credit assessment is indeed revised when the change in operating conditions is large enough to warrant a revision.
- 117 It will also have to be demonstrated that the ECAI reviews each credit assessment at least annually (regardless of whether a reassessment has already been undertaken in response to a significant change in financial conditions). The ECAI should provide a detailed summary on how these reviews are conducted, including the extent of contacts with the senior management of the rated entity.
- 118 The back-testing requirement in paragraph 5(a) of Annex VI of the [Directive 2006/48/EC](#) is viewed as an additional criterion that ECAIs must satisfy before they are granted recognition. One year of back-testing has been deemed necessary to fulfil the criterion "subject to validation based on historical experience." ECAIs will therefore be required to demonstrate and certify that their back-testing has been in place for at least one year.
- 119 The term 'back-testing' means an analysis of 'outcomes' vis-à-vis rated entities/issues designed to assess the 'performance' (e.g. the discriminatory power) of the credit assessments. Back-testing is thus synonymous with the 'validation based on historical

experience' that is mentioned in the CRD's 'objectivity' criterion. For the sake of consistency, back-testing should be undertaken for each of the 'market segments' for which an ECAI is seeking recognition (as explained in paragraphs 85 to 87 above).

- 120 The requirement for ECAIs to inform competent authorities of material changes in their credit assessment methodology is intended to enable competent authorities to assess whether the methodologies continue to meet the CRD criteria on an on-going basis after initial recognition has been granted.
- 121 Preliminary discussions with market participants indicate that it is important to clarify the term 'material change in methodology used for assigning credit assessments' in order to avoid overwhelming competent authorities with information.
- 122 Competent authorities should require ECAIs to inform them immediately of any significant event that would change their performance on any criteria upon which initial recognition was granted. This should be construed to mean any change in methodology that could change a significant proportion of credit assessments in a given market segment.

#### **1.4. Transparency and disclosure**

|                                                                                                                                                                                                                                                                                            |
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| Competent authorities shall take the necessary measures to assure that the principles of the methodology employed by the ECAI for the formulation of its credit assessments are publicly available as to allow all potential users to decide whether they are derived in a reasonable way. |
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- 123 The CRD does not specify either the level of detail that is required or the manner in which the information should be disclosed. Nor does the CRD require competent authorities to elaborate disclosure principles for ECAIs, or to provide a comprehensive disclosure framework where all the information that ECAIs are required to submit could be published. ECAIs are not required to disclose the same information to the public as to competent authorities.
- 124 ECAIs should disclose the principles of their methodology to the public. This shall be an overall yet thorough description of their credit assessment methodologies, presented in a way that is easily understandable to potential users.
- 125 ECAIs should also disclose as promptly as possible material changes in methodology referred to in paragraph 6 of Annex VI of the [Directive 2006/48/EC](#) and in paragraph 107 above.
- 126 ECAIs should use appropriate methods of disclosure to ensure public access to the above-mentioned information. These methods could include display in the public area of the ECAIs' Internet website or free of charge distribution of written publications on request.

## 2. Individual credit assessments

### 2.1. Credibility and Market Acceptance

Competent authorities shall verify that ECAI's individual credit assessments are recognised in the market as credible and reliable by the user of such credit assessments.

Credibility shall be assessed by competent authorities according to factors such as the following:

- (a) market share of the ECAI;
- (b) revenues generated by the ECAI, and more in general financial resources of the ECAI;
- (c) whether there is any pricing on the basis of the rating.
- (ca) in case at least two banks use the ECAI's individual credit assessment for bond issuing and/or assessing credit risks.

An ECAI credit assessment may be used to determine the risk weight of a securitisation position (Article 97(1) of the [Directive 2006/48/EC](#)) only if the competent authorities are satisfied that the ECAI has a demonstrated ability in the area of securitisation, which may be evidenced by a strong market acceptance.

- 127 Evidence of widespread use in the market – by investors, for example – indicates that market participants have a favourable opinion of the credibility and reliability of the ECAI's credit assessments.
- 128 The fact that the market regards an ECAI's credit assessments as credible and reliable may provide competent authorities with a significant degree of confidence as to the appropriateness of the credit assessments as the basis for capital requirement calculations under the Standardised and Securitisation Ratings Based Approaches. The greater the credibility and reliability, the higher this level of confidence is likely to be.
- 129 Conversely, a lower degree of market standing means that competent authorities may themselves need to undertake a greater level of assessment before they can be satisfied that an ECAI fulfils the recognition requirements.
- 130 The factors outlined in the boxed text above will be considered in the context of the market in which the ECAI is operating and in the context of which recognition is sought.
- 131 Competent authorities may also wish to consider other indicators of market credibility not mentioned in the CRD. For example, evidence that a large number of institutions plan to use an ECAI's credit assessments for regulatory capital or other purposes may be viewed as an indication of market credibility for the purpose of ECAI recognition.

## 2.2. Transparency and disclosure of individual credit assessments

*Competent authorities shall verify that individual credit assessments are accessible at equivalent terms at least to all credit institutions having a legitimate interest in these individual credit assessments.*

In particular, competent authorities shall verify that individual credit assessments are available to non-domestic parties on equivalent terms as to domestic credit institutions having a legitimate interest in these individual credit assessments.

Annex IX, Part 3, paragraph 1 states that credit assessments of securitisation positions shall be available publicly to the market. Credit assessments are considered to be publicly available only if they have been published in a publicly available forum and they are included in the ECAI's transition matrix. Credit assessments that are made available only to a limited number of entities shall not be considered to be publicly available.

- 132 The transparency criterion is intended to create a level playing field by ensuring that all institutions "having a legitimate interest" in credit assessments published by the ECAI (public credit assessments), in whatever jurisdiction, have equal and timely access to them.
- 133 Institutions "having a legitimate interest" are those institutions that use the Standardised Approach and the Securitisation Ratings Based Approaches to calculate their regulatory capital requirements, and that intend to use the credit assessments of the respective ECAI for risk weighting purposes. ECAs that wish to be recognised as eligible must make their public credit assessments accessible at least to all institutions fulfilling these criteria.
- 134 "At equivalent terms" does not mean that every institution must be provided access to the credit assessments on identical terms - and in particular, that there be no discrimination in terms of the pricing for access - but rather that under the same (economic) circumstances, there should be no undue (price) discrimination. Competent authorities should pay particular attention to differences in the terms and prices offered to domestic versus non-domestic institutions.
- 135 CEBS considers it necessary to differentiate between situations where ECAs do not charge subscribers for access to their public credit assessments and situations where they do.
- a. Competent authorities should require ECAs that do not charge subscribers for access to their public credit assessments to ensure that a full list of their public credit assessments is available and updated whenever a new credit assessment is issued or an old assessment is revised. One possibility would be for the ECAI to publish a full list of its public credit assessments in the public section of its Internet website and to

update the list whenever such a credit assessment is newly issued or revised.

- b. Competent authorities should require ECAs that permit only paying subscribers to access their credit assessments to ensure that the complete range of its public credit assessments is potentially available to all subscribing institutions and that the list is updated as soon as such a credit assessment is newly issued or revised.

### **Part 3: Mapping**

- 136 When determining which of the credit quality steps the relevant credit assessments of an eligible ECAI are to be associated with, competent authorities shall apply the technical criteria laid down in the CRD<sup>91</sup>. Article 82(1) and Article 98(1) of the [Directive 2006/48/EC](#) state that those determinations shall be objective and consistent.
- 137 Objectivity and consistency in mapping are necessary in order to ensure appropriate levels of capital under the Standardised Approach and the Securitisation Ratings Based Approaches, a level playing field for institutions, and fairness of treatment for ECAs.
- 138 At the same time it is recognised that absolute accuracy in the mapping process is likely to be neither possible - given data constraints and differences in methodology - nor necessary to achieve the objectives of the Standardised Approach and the Securitisation Ratings Based Approaches.

### **General Principles**

- 139 The mapping process should not imply the imposition of additional eligibility requirements on ECAs.
- 140 For the purposes of benchmarking and monitoring ECAs' credit assessments (other than for securitisation and structured transactions), it is recommended that competent authorities use the guidance provided by the Basel Committee in the [Basel II framework published in June 2004](#), Annex 2 ('the Basel II text'). To access the document, please click on either <http://www.bis.org/publ/bcbs107.pdf> or <http://www.c-eps.org/documents/Basel.pdf>
- 141 The use of three-year Cumulative Default Rates (CDRs), evaluated over the longer term (see paragraph 140 below) and on an on-going basis, is considered to provide an appropriate measure of the predictive power of credit assessments in relation to creditworthiness. This choice is consistent with the requirements of the CRD.

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<sup>91</sup> Annex VI, Part 2 for the Standardised Approach; Annex IX for securitisation positions.

- 141 Where significant amounts of quantitative data are available, they will form the central basis of the mapping process. However, the mapping process will also take into account qualitative factors which influence the comparability of the credit assessments' CDRs with the benchmark CDRs (e.g. differences in the definition of default, the methodology for calculating CDRs, etc.).
- 142 Where significant amounts of quantitative data are not available, competent authorities will form their judgement based on both whatever quantitative information is available and an assessment of the meaning of the ECAI's rating scale in comparison with the benchmark. In this situation, competent authorities may take into account the ECAI's own comparison. This judgement will use whatever quantitative information is available, but will be based mainly on a qualitative comparison, incorporating appropriate conservatism where uncertainty remains.
- 143 Supervisory authorities will base their assessments on the credit assessment models, processes, and methodologies presented by the ECAIs, and will in no way seek to influence or change these models, processes, or methodologies.
- 144 The granularity of the mapping process is not linked to the granularity of the methodology used by an ECAI. As long as an ECAI uses the same rating scale (i.e. the same interpretation of the different rating categories) for their broad asset classes, the mapping need not be conducted separately.
- 145 ECAIs will be required to communicate their default rates and the data related to the mapping of securitisation positions annually to the competent authorities, in order to allow them to assess whether the mapping of credit assessments to credit quality steps needs to be updated or changed.
- 146 The cooperative arrangements set up for the recognition process will also be followed by the competent authorities when carrying out the mapping jointly. For the on-going monitoring of the mapping referred to in paragraph 131 above, this implies that a process facilitator will receive the data and dispatch them to all competent authorities concerned.
- 147 This will contribute to a consistent assignment of credit assessments to credit quality steps across Member States.

### **Credit assessments of exposures other than securitisation positions**

- 148 The CRD sets out quantitative and qualitative factors to be taken into consideration.

#### **1. Quantitative factors**

- 149 Quantitative data are the key to ensuring consistency between the credit assessments of different ECAIs and to differentiating between the relative degrees of risk expressed by each credit assessment.

- 150 The CRD suggests that competent authorities use, as quantitative data, “the long-term default rate associated with all items assigned the same credit assessment.”
- 151 Moreover, the CRD requires the competent authorities to “compare default rates for each credit assessment of a particular ECAI and compare them with a benchmark built on the basis on default rates experienced by other ECAs on a population of issuers that the competent authorities believes to present an equivalent level of credit risk.”
- 152 CEBS considers the work conducted to date by the Basel Committee on quantitative factors to be both relevant and appropriate, and proposes to adopt the benchmark and monitoring guidance set out in Annex 2 of the Basel II text.
- 153 In this context, the key variable will be the “cumulative default rates” (CDRs) over a three-year period: that is, the sum of all defaults that have occurred in a given three-year period for all rated items belonging to the same bucket.
- 154 Supervisors will be provided with two separate measures of CDRs: the ten-year average of the three-year CDR as an indicator of the long-term default experience of individual ECAI’s credit assessments, and the two most recent three-year CDRs, where available.
- 155 Using the data provided by the ECAI, competent authorities will compare the most recent ten-year average of the three-year CDR with the proposed long-run ‘reference’ three-year CDRs in Table 2 of Annex 2 of the Basel II text<sup>92</sup>
- 156 In additional, competent authorities will monitor the two most recent three-year CDRs and compare them with the two different CDR levels established in the Basel II text: the ‘monitoring level’ and the ‘trigger level’.<sup>93</sup> The methodology laid out in Annex 2 of the Basel II text will help supervisors assess whether the ECAI’s default rates are materially and systematically higher than these benchmarks.
- 157 Based on this assessment, competent authorities will decide whether to assign a less favourable credit quality step. If the ECAI can demonstrate that higher observed or estimated CDRs are not due to weaker assessment standards or miscalculations, competent authorities may decide to leave the initial mapping unchanged.
- 158 For recently established ECAs and those that have compiled only a short record of default data, competent authorities will ask the ECAI for its two most recent CDRs and a projection of the ten-year average of the three-year CDR, i.e. the value that the ECAI believes

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<sup>92</sup> It should be noted that the numbers provided for the long-term benchmarks are mid-point numbers. Consequently, supervisory authorities will not expect the data provided by ECAs to coincide exactly with these numbers.

<sup>93</sup> In this case, both benchmarks are considered as upper limits.

to be the long-term default rate associated with all items assigned the same credit assessment.

- 159 Competent authorities will review this assessment on the basis of the availability of data and the methodology used by the ECAI in question, comparing it with those used to calculate the benchmark. Based on the consideration of such qualitative factors, competent authorities may then adjust the mapping of the ECAI accordingly. Where uncertainty remains, competent authorities should incorporate appropriate conservatism into the final mapping.
- 160 For ECAIs that adopt significantly different approaches, supervisors should consider adjusting their assessment on the basis of qualitative factors as set out below.

## **2. Qualitative factors**

- 161 The CRD requires competent authorities to consider qualitative factors such as the pool of issuers covered by the ECAI, the range of credit assessments that it assigns, the meaning of each credit assessment, and the ECAI's definition of default.
- 162 Qualitative factors will play a crucial role in the mapping process in the following situations:
- When the ECAI uses methodologies (e.g. definition of default, etc.) similar to those used by the international entities upon which the Basel Committee constructed its benchmarks, competent authorities will use qualitative factors to adjust their quantitative assessment before finalising the assignment of each of the ECAI's credit assessments to the credit quality steps established in the CRD.
  - When the ECAI uses different methodologies, it will be required to provide its own assessment of whether and to what extent its methodology differs from that used to calculate the benchmarks in the Basel II text. In this way, supervisors will get a better understanding of what a credit assessment represents and the risk level associated with it. This may lead to the assignment of similar CDR data to different credit quality steps from those set out in the Basel text.
  - Recently established ECAIs and ECAIs that have compiled only a short record of default data would need to demonstrate to what extent they believe that the default data they use are a long-term default rate. Qualitative factors would be particularly important in making that demonstration.
- 163 In their assessment, competent authorities will take into account the qualitative variables indicated in the CRD:
- a. The definition of default. An ECAI using a more stringent definition of default than that used in the international benchmark will report more default events, meaning that CDRs could be overstated. The opposite situation could also occur: i.e. an ECAI using a less stringent definition of default.

- b. The pool of issuers covered by the ECAI. ECAIs may use a static pool of issuers or adjust the pool periodically, for example for withdrawn credit assessments.
  - c. The statistical significance of ECAIs' default rates. In particular, the number of rated issues shall be sufficiently large to ensure the statistical significance of CDRs. Particular attention will be paid to situations where the ECAI is sectorally-focused or geographically specialised, or where the ECAI rates portfolios for which default data are very scarce.
  - d. The meaning of the credit assessment, i.e. the substance of the opinion represented by a particular rating grade.
- 164 In addition to the qualitative factors set out in the CRD, competent authorities should consider other relevant factors such as:
- e. The variable used to weight default events. Different variables, such as the number of issues, the currency value of exposures rated, or other characteristics, can be used to weight default events. The choice of variable may have an impact on the results.
  - f. Geographic coverage: the use of regional or global data.
  - g. Dynamic properties and characteristics of the rating system or methodology (a 'point-in-time' rating system or a 'through the cycle' system). This can be assessed in general terms without entering into the details of the ECAI's default model.
- 165 Supervisors may consider the mapping on the basis of additional information and analysis provided by the ECAI.

### **Credit assessments of securitisation positions**

- 166 The CRD<sup>94</sup> requires a separate mapping of credit assessments securitisation positions. For ease of reference, the paragraphs below refer to this simply as 'securitisation mapping.'
- 167 Securitisation mapping and the mapping of credit assessments discussed above follow the same principles of objectivity and consistency. However, there are likely to be important differences. First, securitisation transactions have unique characteristics, and the market is highly innovative and constantly evolving. Second, securitisation mapping under the Internal Risk-Based (IRB) Approach would be more finely graduated than the mapping of general credit assessments under the Standardised Approach.
- 168 Unlike the mapping of other ECAI credit assessments, the CRD does not require competent authorities to create a 'benchmark' for default rate comparison. This reflects the difficulties that would surround the creation of such a benchmark at this stage in the

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<sup>94</sup> Article 98(3) of the Directive 2006/48/EC requires competent authorities to determine with which of the credit quality steps set out in Annex IX the relevant credit assessments of an eligible ECAI are to be associated. Those determinations shall be objective and consistent.

development of the securitisation market. The CRD<sup>95</sup> requires competent authorities to consider “quantitative factors, such as default rates and loss rates and qualitative factors such as the range of transactions assessed by the ECAI and the meaning of the credit assessment.”

- 169 Preliminary discussions suggest that individual ECAIs construct their methodologies specifically to give credit assessments a consistent meaning across different structured product classes. This implies that competent authorities could treat structured products as a single market segment for mapping purposes, and that the mappings used for securitisation transactions will be those derived for all structured products.
- 170 Securitisation mapping, like the mapping of other credit assessments, should be carried out within the framework of the joint assessment process outlined above.
- 171 In mapping securitisation position credit assessments into the credit quality steps of the CRD, supervisors will take into consideration quantitative factors and qualitative information, including those set out in the following paragraphs.

## **1. Quantitative factors**

- 172 Quantitative factors will be a key consideration in mapping securitisation, as they are in mapping other credit assessments. CEBS recognises that many potential ECAIs do not target quantitative outcomes for their assessments, seeking instead to achieve consistent rank ordinal assessments. Nonetheless, consideration of quantitative 'performance' studies of those assessments over time, in line with the CRD's requirement, is a key element in providing a mapping in a consistent and objective manner.
- 173 Competent authorities will consider data relating to the default/impairment rates associated with different credit assessments. Competent authorities remain open as to the extent to which impairment rates can provide an appropriate proxy for the measurement of the 'performance' of securitisation credit assessments over time in the absence of more complete recovery rate data. Competent authorities will also consider transition matrices when this provides additional useful information.
- 174 In comparing default/impairment rates, competent authorities will work with the ECAIs in question to seek to understand fully the definition of default/impairment on the basis of which they carry out their data analysis. It will be important for competent authorities to understand the ECAI's approach to this issue. In view of the long maturity of many securitisation transactions and the fact that contractual default/impairment may be tied to this long

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<sup>95</sup> Annex IX, Part 3, paragraph 7 of the Directive 2006/48/EC

maturity, ECAIs may use varying definitions of default/impairment as alternatives to or proxies for contractual default.

- 175 It is expected that most ECAIs will produce ratings performance data using a 'cohort' approach – i.e. an approach that incorporates the effect of ratings migration in its analysis of the performance of the rating. While ECAIs may also produce data based on an 'original rating' analysis, CEBS considers that – as for other credit assessments - a 'cohort' approach is likely to be the most meaningful for the purposes of mapping securitisation assessments.
- 176 In considering quantitative factors, competent authorities will also consider the approach of the ECAI to aspects such as 'curing' (the subsequent repayment of missed payments) and withdrawn credit assessments, and how these affect the ECAI's ratings 'performance' studies.
- 177 'Seasoning' is another factor that competent authorities will consider. In particular, given the possible difference between the loss-distribution curve for asset-backed securities as compared with corporate and other debt, the period over which rating performance is considered – e.g. three years versus five years – may be significant.
- 178 Different ECAIs have different approaches to the meaning of their securitisation credit assessments. For example, some seek to produce a rank ordering with respect to the loss that may be suffered by the tranche in question, while others base their rank ordering to a greater extent on the likelihood of the tranche suffering 'first euro' impairment. Nonetheless, there seems to be a broad consensus that the question of loss is an important factor to be taken into consideration. At this stage in the development of the market, it seems likely that the amount of loss data available will continue to grow. Competent authorities will seek to take into account the loss/recovery rate data that are available in relation to the different ECAIs ratings. It is expected that these data will improve in significance over time and that recovery rate studies will become an increasingly rich source of information.

## **2. Qualitative factors**

- 179 The CRD requires competent authorities to take qualitative as well as quantitative factors into consideration in mapping securitisation credit assessments into credit quality steps. Competent authorities believe that this is likely to be an important aspect, particularly when quantitative data are less than conclusive, as noted above in paragraph 148.
- 180 In assigning securitisation credit assessments, ECAIs often adopt an 'indicative' approach. That is, they indicate what is required in order for a particular tranche of a transaction to achieve a particular credit assessment level. This means that an ECAI's assignment methodology for ABS credit assessments can provide important insights in the mapping process. It is also likely to be useful, where

relevant, to consider the relationship between an ECAI's securitisation credit assessments and its other credit assessments – in particular in relation to the 'meaning' of the different assessments.

- 181 A notable feature in the development of the securitisation market over recent years has been the degree to which the market has been 'ratings-driven.' That is, the credit assessments assigned by ECAIs have played an important role in the structuring and marketing of transactions and in the provision of investor information.
- 182 In this context, competent authorities think that it will be highly relevant to consider the way in which market participants view the published credit assessments of different ECAIs. Accordingly, in mapping an ECAI's securitisation credit assessments to the CRD's credit quality steps, competent authorities will take into account market information concerning the degree to which the published credit assessments of the ECAI in question are regarded as being similar in meaning, as an indicator of creditworthiness, to those of its peers. There is some evidence to indicate that market participants regard the published securitisation credit assessments of a number of relevant ECAIs as being in many respects equivalent. It is expected that studies on market information - e.g. credit spreads on securitisations rated by an ECAI as compared to its peers - will also become an increasingly rich source of information.

### **Short-term credit assessments**

- 1832 Competent authorities propose to base the mapping of short-term credit assessments on the mapping of long-term credit assessments explained above, and on the internal mapping of short-term to long-term credit assessments undertaken by the ECAI. Should any inconsistencies arise, competent authorities will seek to adjust the mapping accordingly (e.g. by adopting a conservative approach).

### **Credit Assessments of Collective Investment Undertakings (CIUs)**

- 184 According to Annex VI, Part 1, paragraph 75 of the [Directive 2006/48/EC](#), exposures in the form of CIUs for which a credit assessment by a nominated ECAI is available shall be assigned a risk weight in accordance with the assignment by the competent authorities of the credit assessments of eligible ECAIs to six steps in a credit quality assessment scale
- 185 For CIUs, however, ECAIs usually issue several assessments with distinct meanings (e.g. assessments of the asset quality of a fund, of the quality of the management of the fund, or of the volatility of the fund). It has therefore been deemed necessary to define which of the assessments of a CIU should be eligible for risk weighting purposes in the context of the CRD and how they should be mapped to the individual credit quality steps.

## Eligible assessments

- 186 In order to be eligible for the purposes of the CRD, credit assessments for CIUs must fulfill the following criteria:
- 187 The assessment of the credit quality of the CIU must depend primarily on the credit quality of the underlying assets.
- 188 Where other factors have a significant influence on the assessment, supervisors shall consider the extent and nature of that influence in determining whether the assessment remains a credit assessment for these purposes and whether any adjustment to the mapping may be required.
- 189 Only assessments for fixed-income CIUs should be eligible, since the CRD does not allow the use of credit assessments for other asset classes (e.g. equity) within the Standardised Approach.

## Mapping

- 190 An assessment of the credit quality of a CIU which meets the criteria set out above can be mapped similarly to the other fundamental credit assessments of the respective ECAI. It has therefore not been considered necessary to develop an alternative mapping approach for CIU assessments.

## Part 4: Export Credit Agencies

- 191 Article 80(1) of the [Directive 2006/48/EC](#) states that credit quality may be determined by reference to the credit assessments of ECAIs in accordance with the provisions of Article 81 to 83 or the credit assessments of Export Credit Agencies as described in Annex VI, Part 1. The CRD limits the use of ECA's credit assessments to exposures to central governments and central banks. Therefore, institutions are allowed to use Export Credit Agency credit assessments to calculate the risk weight of their exposures to central governments and central banks, in addition to ECAIs' credit assessments for the other types of exposures.
- 192 Paragraph 7, Part 1, Annex VI of the Directive 2006/48/EC provides that the credit assessments of an Export Credit Agency can be used for calculating capital requirements if either of two conditions are met:
- a. The credit assessment is a consensus risk score from an Export Credit Agency participating in the [OECD Arrangement on Guidelines for Officially Supported Export Credits](#), or
  - b. The Export Credit Agency publishes its credit assessments, the Export Credit Agency subscribes to the OECD agreed methodology, and the credit assessment is associated with one of the eight minimum export insurance premiums (MEIP) that the OECD agreed methodology establishes.

- 193 It has not been deemed necessary to set up a recognition process for Export Credit Agencies equivalent to the one required for ECAs. Competent authorities shall simply ask the institutions that wish to use an Export Credit Agency's credit assessments to demonstrate that one of the above conditions is met. Thus, eligible credit assessments are either:
- a. Consensus risk scores from the OECD Arrangements, or
  - b. Any credit assessments of participants in the OECD Arrangements following the agreed methodology that are not consensus risk scores, regardless of whether the country in question has been assigned a consensus risk score.
- 194 The rules set out in Annex VI, Part 3, Paragraphs 2 and 3 of the [Directive 2006/48/EC](#) should apply to Export Credit Agencies' credit assessments. This means that an institution which decides to use the eligible credit assessments of an Export Credit Agency or OECD participants' consensus risk scores must use those credit assessments consistently for all exposures belonging to the exposure class. Moreover, an institution which decides to use the eligible credit assessments of an Export Credit Agency must use them in a continuous and consistent way over time.
- 195 To avoid arbitrage and ensure consistency between the two types of external credit assessments, the rules set out in Annex VI, Part 3, Paragraphs 6 and 7 of the Directive 2006/48/EC will also apply. The CRD states that if two credit assessments are available and the two correspond to different risk weights for a rated item, the higher risk weight shall be applied. If more than two credit assessments are available for a rated item, the two assessments generating the two lowest weights shall be referred to. If the lowest risk weights are different, the higher risk weight shall be applied; if the two lowest risk weights are the same, that risk weight shall be applied.
- 196 Finally, Annex VI, Part 1, Paragraph 8 of the Directive 2006/48/EC links the eight minimum export insurance premiums (MEIP) established under the OECD methodology and the risk weights available under the Standardised Approach.

## **Annex 1**

### **Common Basis Application Pack**

#### **GENERAL INFORMATION**

-The type of application: to use ECAI credit assessments for risk-weighting in the Standardised Approach, or for risk-weighting of securitisations.

-The market segments for which the applicant is seeking recognition.

-The type of credit assessments provided: solicited or/and unsolicited, with a brief explanation of the rationale behind the policy.

-The competent authorities where the applicant is seeking recognition or intends to seek recognition.

-The countries where the applicant is active.

#### **Presentation of the ECAI**

-An overview of the legal structure of the ECAI and the group to which it belongs: ownership, major subsidiaries, ancillary or other services provided, etc. The information on ownership should include a list of shareholders that hold more than, for example, 10 percent of the ECAI's equity. This threshold may vary depending on the ownership structure of the ECAs.

-The total number of full-time employees.

-The total number and percentage of revenues from major customers and/or subscribers (e.g. customers or subscribers accounting for 5% or more of total revenues. The threshold may vary depending on the ECAs).

-Financial information demonstrating the financial soundness of the ECAI: the ECAI's financial statements from the past three years and forecasts for the next three years where applicable; alternatively, letter of support from the parent entity.

-Do you adhere to a code of conduct similar to market accepted standards or which is in line with internationally recognised principles?

#### **Technical criteria laid down in the CRD**

The applicant shall include in its application a description of the core rating process for each market segment or securitisation position and each geographical area in which it is seeking recognition. The applicant is not required to provide duplicate answers and information for this application pack, but will clearly indicate for each recognition criteria what differs from one area of recognition to another.

Competent authorities are interested only in information that is relevant to the market segments and/or securitisation positions for which the application is made.

## **METHODOLOGY**

### **1. Objectivity**

#### **Question:**

How do you ensure that the methodology used for assigning credit assessments is rigorous, systematic and subject to validation based on historical experience?

#### **Minimum information to be provided to the competent authorities to enable them to verify that the criterion is met:**

1) A high-level description of the credit assessment methodology and processes and how the methodology is determined, implemented, and changed. This description shall include a description of processes in place to ensure the consistent application of the assessment methodologies across all credit assessments, in particular the role of rating committees and guidelines governing them, the extent of input from rated entities, the access to non-public information, etc.

2) For each of the asset groupings within which a core methodology is applied consistently (for example, structured finance, public finance, or commercial entities, as mentioned above), a high-level description of quantitative inputs: key variables, data sources, assumptions and quantitative techniques used, extent of input from rated entities, etc.

3) For each of the asset groupings within which a core methodology is applied consistently (for instance structured finance, public finance, commercial entities, as mentioned above), a high-level description of qualitative inputs in particular the scope of qualitative judgement e.g. regarding the strategy, business plans of the rated entities, etc.

4) A summary by geographical area of the major differences in the core methodologies.

5) A description of the methodology used to verify the accuracy, consistency, and discriminatory power of the rating systems, with details on the results and conclusions generated by such analysis.

### **2. Independence**

#### **Question:**

How do you ensure that the methodology used is free from external political influences or constraints and from economic pressures that could influence the credit assessment?

#### **Minimum information to be provided to the competent authorities to enable them to verify that the criterion is met:**

1) A description of the procedures aimed at ensuring fair and objective credit assessments: mechanisms to identify, prevent, manage and eliminate actual or potential conflicts of interest.

- 2) A detailed description of the safeguards in place when shareholders, subsidiaries, or other entities belonging to the group are rated.
- 3) Demonstration and self-certification of the existence of an internal audit function and/or that there are means to ensure that internal procedures are implemented effectively.
- 4) Demonstration and self-certification that members of the rating teams and committees have appropriate and requisite skills – including quantitative expertise – and experience in credit assessment, and that these skills are maintained or improved over time through adequate training programmes.
- 5) A description of the main features of the ECAI's internal code of conduct.
- 6) Demonstration and self-certification that the remuneration policy of the staff involved in credit assessment does not affect the production of independent and objective credit assessments: e.g. certification that analysts' remuneration is not tied to credit assessment decisions, fees from issuers, or revenues from investors or subscribers.
- 7) Details of the ECAI's fee policy.
- 8) Self-certification that the staff involved in the credit assessment process are not engaged in any business relationships with rated entities which could hinder the issuance of independent and high-quality credit assessments.

### **3. On-going review**

#### **Questions:**

- 1) Are your credit assessments subject to on-going review which is carried out at least annually and after all significant events?
- 2) To what extent are your credit assessments responsive to changes in the financial conditions?
- 3) Do you have procedures in place that ensure that competent authorities are promptly informed of material changes, and if so, what are they?

#### **Minimum information to be provided to the competent authorities to enable them to verify that the criterion is met:**

- 1) General information on rating reviews: e.g. the process in place, main characteristics, scope, frequency, people/teams involved, means used, treatment, main phases of the monitoring process, data updates, information from rated entities taken into account, automatic warning systems, mechanisms that allow systematic errors in credit assessments to feedback into potential changes in ratings method, etc.
- 2) A summary of the outcome of the reviews carried out
- 3) Demonstration that a back-testing system is in place and has been up and running for at least one year.

4) The extent of contacts with the senior management of the rated entities (this information is to be provided upon request of the competent authority).

#### **4. Transparency and disclosure**

##### **Question:**

How (by what means and in what language) and to whom do you disclose the principles of the methodology you use?

##### **Minimum information to be provided to the competent authorities to enable them to verify that the criterion is met:**

- 1) A demonstration that the principles of the methodology employed by the ECAI for the formulation of its credit assessments are disclosed.
- 2) Descriptions of the ways used to make methodologies publicly available, and of the terms of access to the credit assessments by all potential users
- 3) A description of transparency policy with regard to the types of credit assessment: solicited or unsolicited.

### **INDIVIDUAL CREDIT ASSESSMENTS**

#### **5. Credibility and market acceptance**

##### **Question:**

How could you prove your credibility and market acceptance?

##### **Minimum information to be provided to the competent authorities to enable them to verify that the criterion is met:**

- 1) Any evidence demonstrating market reliance on the credit assessments, such as market share, number of issuers, how long the ECAI has been active in the market, the revenues generated by the rating activities, or any other proof.

#### **6. Transparency and disclosure**

##### **Questions:**

- 1) How do you ensure that credit assessments are accessible at equivalent terms at least to all institutions having a legitimate interest in them?
- 2) In particular, how do you ensure that credit assessments are accessible at equivalent terms to both domestic and non-domestic parties having a legitimate interest?

##### **Minimum information to be provided to the competent authorities to enable them to verify that the criterion is met:**

- 1) A high-level description of the disclosure procedures in place

## **MAPPING**

**Question:** None

**Minimum information to be provided to the competent authorities to enable them to perform the mapping the credit assessments of exposures other than securitisation positions:**

- 1) The definition of default
- 2) The CDR over a three-year period for each credit assessment category (to be provided annually if the ECAI is recognised as eligible), at least the two most recent CDRs, if available
- 3) The ten-year average of the three-year CDR. If not available, an indication of the ECAI's expectation concerning the long term default rate.
- 4) If a target probability of default is used, the target probability of default for each credit assessment category,
- 5) Description of the methodology to calculate the CDRs: selection of pool (static versus dynamic/adjusted), definition of default, aggregation of defaults (weighting mechanism),
- 6) The statistical significance of the default rates,
- 7) Dynamic characteristics of the rating methodology (point-in-time or through the cycle),
- 8) The meaning of the credit assessment categories,
- 9) The range of credit assessments that the ECAI assigns,
- 10) The time horizon of the credit assessment,
- 11) Transition matrices,
- 12) Geographic coverage.

**Minimum information to be provided to the competent authorities to enable them to perform the mapping of securitisation positions**

- 1) the definition of default/impairment on the basis of which the default/impairment rates are computed
- 2) Ratings' performance data, accompanied by an explanation of its main features (e.g. the reasons underlying the determination of the time horizon over which the study has been carried out and how curing and withdrawn credit assessments impact the rating performance studies; how seasoning is taken into account)
- 3) loss/recovery data
- 4) Information referred to point 8 to 12 above

**Additional information for CIUs**

- 1) Presentation of the CIU ratings considered as assessing primarily the credit quality of the underlying assets
- 2) Description of the factors and the extent to which they have been taken into account
- 3) Information referred to point 8 to 12 above.

## Prudential Filters

<http://www.c-ebs.org/News--Communications/Archive/2004/CEBS-guidelines-on-prudential-filters-for-regulato.aspx>

### **CEBS GUIDELINES ON PRUDENTIAL FILTERS FOR REGULATORY CAPITAL<sup>96</sup>**

- 1 From January 1st, 2005 European listed companies, at the minimum, will have to publish consolidated financial statements based on the new International Financial Reporting Standards (IFRS) rules. The IFRS accounting developments may affect the magnitude, the quality and volatility of banks' available regulatory capital. As accounting numbers remain the basis for the computation of prudential ratios, this change will have a significant impact on the solvency ratios and, primarily, on the content of own funds.
- 2 In response to a request from the Banking Advisory Committee, CEBS has proposed to the European Commission on 19 October 2004 a first set of technical advice on the use of prudential filters in the context of the new IFRS and the proposed Capital Requirements Directive. In addition to the prudential filters proposed to the European Commission, CEBS has developed supplementary prudential filters. CEBS suggests member states to apply the guidelines to institutions applying IFRS for prudential purposes in order to avoid any unwanted change likely to be introduced by the new accounting rules; and that CEBS monitors the application thereof. For consistency purposes, CEBS also encourages member states to consider the need to apply the guidelines to institutions following national GAAP to the extent that they are similar to IFRS.
- 3 CEBS members apply these CEBS guidelines on prudential filters on a best effort basis for their IFRS based prudential returns. Their application voluntary and their implementation at national level has been made in accordance with national procedures.
- 4 Accounting changes that will have an impact on Own funds have been prioritized. In this regard, the objective of the prudential filters should be to maintain the current definition - and quality - of regulatory capital for those institutions applying IFRS, or

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<sup>96</sup> As to the history of the guidelines on prudential filters for regulatory capital, the document can be also found under the following link on CEBS website: <http://www.c-ebs.org/News--Communications/Archive/2007/CEBS-PUBLISHES-AN-ANALYTICAL-REPORT-ON-PRUDENTIAL.aspx> . It should in that context also be noted that an analysis has been carried out to assess CEBS' members compliance with these guidelines and to present their impact in quantitative terms on regulatory own funds. The related analytical report, which also provides a basis for discussion on the possible scope for further convergence of these filters, can be accessed here: <http://www.c-ebs.org/News--Communications/Archive/2007/CEBS-PUBLISHES-AN-ANALYTICAL-REPORT-ON-PRUDENTIAL.aspx>

institutions following national GAAP to the extent that they are similar to IFRS, for prudential purposes.

- 5 In order to reach a common level playing field across Europe and G10 countries CEBS' recommendations on prudential filters are in line with the Basel Committee's work on the same subject.

### **CEBS Guidelines on the Use of Prudential Filters in the Context of the New IFRS**

- 6 CEBS proposes the following adjustments and prudential filters on institutions' own funds:

#### ***The boundary between debt and equity***

- 7 Two significant issues related to the distinction between debt and equity arise from [IAS 32](#). Firstly, some instruments classified as eligible regulatory capital under the current solvency directive will be reclassified as liabilities under this new accounting standard. Shares in co-operative entities and certain preferred shares are likely to be affected. Secondly, some liabilities with embedded derivatives that are not classified as accounting capital today may contain an equity-type embedded derivative which will be, in the future, automatically classified as equity. For example, shares in co-operative entities would continue to qualify as capital, and the equity component of a liability which is not currently included in capital will continue to be excluded.
- 8 In this context, the CEBS recommends continuing the current prudential treatment in determining the classification of instruments for regulatory capital purposes. CEBS opinion is that issued financial instruments can be included in own funds if they respect the criteria of the directive on own funds regardless of the classification in the new IFRS and for the amount which would exist if no separation between liabilities and equity had been made. Furthermore, competent authorities should have the possibility to exclude from regulatory capital some instruments booked in equity or to classify these instruments as hybrid original own funds or additional own funds.

#### ***Available-for-sale***

- 9 The available-for-sale portfolio comprises equities, loans and receivables as well as other financial instruments (other available-for-sale assets). CEBS proposes that for fair value revaluation reserves on available-for-sale assets the following prudential filters shall apply:

- For equities, unrealised losses should be deducted after tax from original own funds and unrealised gains should only partially be included in additional own funds before tax.

- For loans and receivables, the unrealised gains and losses, apart from those related to impairment, are neutralised in own funds after tax.
  - For other available for sale assets, (for example debt securities, financial instruments subject to interest rate risk) two methods can be applied. According to the first one, items classified in this portfolio should be treated as equities, under the second method; they should be treated as loans and receivables. As a related issue, CEBS considers that there should be a consistent treatment of gains and losses resulting from a transaction whereby a cash flow hedge is created for an available for sale instrument: i.e. if the gains on the hedged item are recognized in additional own funds, so should the results of the corresponding cash flow hedging derivative.
- 10 As a general principle, no regulatory adjustments should be made to impairment losses. Impairment related to credit risks should always be taken into account via the profit and loss account and therefore deducted from original own funds. Any additional supervisory formal recommendation or requirement regarding credit risk impairment should also be deducted from original own funds.
- 11 In the context of prudential filters partially means that at least the tax effect should be taken into account.

### ***Fair value option***

- 12 A specific case can be made on the impact of the fair value option on a credit institution's liabilities that are due to changes in the institution's own credit standing as defined in [IAS 32](#).
- 13 In accordance with the proposal of the Basel Committee, CEBS proposes as a general principle, that institutions make adequate disclosure to their supervisors with regard to the quantitative impact of the use of the fair value option on the carrying value of financial assets on the balance sheet and on retained earnings. It applies in particular to the fair value option on financial assets as a result of the version of [IAS 39](#) endorsed by the European Commission. In such a case, national competent authorities may decide whether prudential filters are needed; otherwise inclusion in original own funds will be allowed.
- 14 CEBS proposes exclusion from own funds of any cumulative unrealized gains and losses arising from changes in an institution's own credit standing as a result of the potential future application to liabilities of the fair value option. The Fair Value Option is of course currently not available for financial liabilities under the EU carved out version of [IAS 39](#).

### ***Cash flow hedges***

- 15 CEBS proposes that institutions shall not include in own funds the fair value reserves related to cash flow hedges of financial

instruments measured at amortized cost and forecast transactions other than cash flow hedges on available for sale assets where the treatment should be consistent with that of the reserve created for the relevant assets. There should be a consistent treatment of gains and losses resulting from a transaction whereby a cash flow hedge is created for an available for sale instrument: i.e. if the gains of the hedged item are recognized in additional own funds, so should the results of the corresponding cash flow hedge.

### ***On investment properties and own use properties***

- 16 For investment properties and own use properties (property plant and equipment) valued under the fair value model, CEBS proposes to deduct cumulative unrealized losses from original own funds and to partially include in additional own funds cumulative unrealized gains. In the context of prudential filters, partially means that at least the tax effect should be taken into account.
- 17 In general there is no need for regulatory adjustments in cases where the cost method is applied. However, national competent authorities are encouraged to consider the need for transferring unrealized gains, if any, resulting from the first time application of the cost method to properties from original own funds to additional own funds.

### ***Securitisation***

- 18 CEBS acknowledges the fact that securitisation transactions fulfilling the criteria of the directives should follow the revised prudential framework regardless of the accounting treatment

### ***Risk weighted assets***

- 19 In order to mirror the impact of prudential filters on own funds, national competent authorities may require some adjustments to the balance sheet value of the exposures used in the computation of an institution's risk weighted exposures based on accounting numbers.

### ***Current prudential classification and definition***

- 20 IFRS may change the current prudential classification of financial instruments and have consequences on the boundary between trading and banking books, even if this has no impact in the amount of own funds. CEBS considers that the impact on the classification of items should not be carried through to prudential regulation and proposes accordingly to keep the current prudential definition of the trading portfolio.

### ***No need for prudential filters in other areas***

- 21 For the time being, CEBS does not intend to encourage national competent authorities to apply any adjustments or prudential filters on existing intangible assets, including goodwill, deferred tax assets, pension cost, stock option costs and leasing, given that the impact on own funds of the application of IFRS is inexistent or small or given that the new accounting treatment is considered more prudent than before. For existing intangible assets, including goodwill, and deferred tax assets the current regulatory capital treatment may continue. For pension costs, stock option costs and leasing no regulatory capital adjustments will be applied in regulatory capital and accordingly the adoption of IFRS will impact on profit and loss. However, consideration should be given to the need for any transitional/other arrangements for the first time adoption of the standards, or to accommodate particular national circumstances for the mentioned items.

***Scope and method of consolidation***

- 22 Consideration of the scope and methods of consolidation is still underway. The outcome of this exercise and possible proposals will be communicated subsequently.



## V. Guidelines on the Supervisory Review Process

### Guidelines on the Application of the Supervisory Review Process under Pillar 2.

#### Guidelines on the Application of the Supervisory Review Process under Pillar 2<sup>97</sup>

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<sup>97</sup> As to the history of the guidelines on the application of the Supervisory Review Process under Pillar 2, the link to the guidelines on the CEBS website is under the following link: <http://www.cebs.org/documents/Publications/Standards---Guidelines/files-from-old-website/GL10.aspx>

## Executive Summary

This paper is the final version of CEBS' guidelines "The Application of the Supervisory Review Process under Pillar 2".

The paper reflects comments and suggestions CEBS has received in feedback on the two previous consultation papers. These guidelines are designed to promote convergence of supervisory practice and consistency of approach, taking into account market trends and national practices, to achieve a sound and efficient market.

CEBS recognises the need for increased supervisory co-operation, and industry concerns that a lack of co-ordination could give rise to duplication of supervisory effort. These guidelines therefore include some reflections on this matter, taking account of the more general guidelines issued by CEBS on home host supervisory cooperation.

### Principal aims of Pillar 2

The underlying aim of the Pillar 2 processes is to enhance the link between an institution's risk profile, its risk management and risk mitigation systems, and its capital. Institutions should themselves develop sound risk management processes that adequately identify, measure, aggregate and monitor their risks. Institutions are expected to have an adequate assessment process that encompasses all the key elements of capital planning and management and generates an adequate amount of capital to set against those risks.

Institutions should 'own', develop and manage their risk management processes; the ICAAP belongs to the institution and supervisors should not dictate how it is applied. The task of the supervisory authority is to review and evaluate the ICAAP and the soundness of the internal governance processes within which it is used.

The dialogue between an institution and its supervisor is a key part of the supervisory review process. This paper highlights the respective involvement of supervisory authorities and institutions and the interaction between them, with the aim of making this dialogue clear and consistent. The dialogue should embrace all aspects of business risk and internal governance (including risk control, compliance and internal audit). In order to ensure transparency and consistency in the dialogue, and to promote convergence of supervisory practices, the supervisory processes have been laid out in detail.

The intensity and depth of the dialogue should be proportionate to the nature scale, complexity and systemic importance of the institution. For example, a small non-complex institution would not be expected to have a sophisticated ICAAP, and its supervisor should not necessarily subject it to an intense and comprehensive dialogue.

The CRD provides supervisors with several tools, including setting a Pillar 2 capital requirement. However, supervisors fully recognise that while capital has an important role to play in the mitigation of risks it may not

always be the sole or best solution to mitigate risk. Depending on the circumstances, it may therefore be used on its own, in combination with other supervisory measures, or other measures be taken instead. Accordingly, supervisors will give due weight the application of qualitative measures which are applied by an institution within its ICAAP.

This set of guidelines has been incorporated into this guidebook for institutions and supervisory authorities on how to approach their obligations under the CRD (the Directives [2006/48/EC](#) and [2006/49/EC](#)).

## **Chapter 1: Introduction**

This paper sets out guidance on the supervisory review process (SRP). It represents the collective views of EU supervisors on the standards (including standards on internal governance) that credit institutions and investment firms are expected to observe and the supervisory practices that supervisory authorities will apply.

The guidance elaborates on the relevant provisions of the Capital Requirements Directive (CRD): Articles 22, 123, 124 and 136 and annexes V and XI of the Directive 2006/48/EC.

This guidance is a key element of CEBS' programme to:

- Foster convergence of supervisory practices, which in turn should help level the playing field for institutions.
- Enable supervisors to carry out their tasks without imposing an undue supervisory burden on institutions.
- Promote a common understanding and culture among European supervisors.

As part of this programme CEBS will encourage the exchange of information between EU supervisors, including the sharing of practical experiences in applying the SRP and the interaction of the ICAAP-SREP.

In order to fully capture the implications of this guidance, it should be read in conjunction with CEBS' guidelines on Home-Host and Supervisory Disclosure.

### ***Key Components***

#### ***SRP***

The purpose of the SRP is to ensure that institutions have sufficient capital to support all material risks to which their business exposes them. It should therefore reinforce the link between risk and capital, so that the institution's risk management strategy, approaches and systems are integrated with its capital planning. Institutions are expected to develop and use sound risk management techniques in monitoring and measuring their risks.

Four internationally agreed principles underpin supervisory review:

- Institutions should have a process for assessing their overall capital adequacy in relation to their risk profile and a strategy for maintaining their capital levels.
- Supervisors should review and evaluate institutions' internal capital adequacy assessments and strategies, as well as their ability to monitor and ensure their compliance with own funds requirements. Supervisors should take supervisory action if they are not satisfied with the result of this process.

- Supervisors should expect institutions to operate above the minimum own funds requirements and should have the ability to require them to hold capital in excess of the minimum.
- Supervisors should seek to intervene at an early stage to prevent capital from falling below the minimum levels required to support the risk characteristics of a particular institution and should require rapid remedial action if capital is not maintained or restored.

These principles have been incorporated into the CRD. Under the first principle, the management body (both the supervisory and management function) of an institution bears primary responsibility for ensuring that processes are in place to ensure that the institution holds sufficient capital to meet both its own funds and its internal capital targets. This principle is codified in Article 123 of the [Directive 2006/48/EC](#) and elaborated in the chapter of this paper on the internal capital adequacy assessment process (ICAAP). Sound internal governance is especially important in this context, and CEBS has developed further guidance based on Article 22 & annex V of the Directive 2006/48/EC.

The remaining principles - which require supervisors to review and evaluate the ICAAP, to perform their own assessment of the institution's risk profile, to identify any weaknesses or inadequacies, and to take supervisory measures if necessary - are codified in Articles 124 and 136 and annex XI of the Directive 2006/48/EC. These are elaborated in the chapters of this paper on the supervisory review and evaluation process (SREP), risk assessment system (RAS), and Dialogue.

The SRP extends beyond the ICAAP and SREP to include ongoing supervisory monitoring of the institution's compliance including the terms and conditions in the CRD for being granted approval to use the IRB and AMA (adequacy of risk evaluation systems), the conditions laid out under Article 145 for ongoing use of these models, large exposures etc. This guidance does not cover these wider issues, although further guidance may be developed in due course.

### ***Internal Governance***

Internal Governance is codified in Article 22 & annex V of the Directive 2006/48/EC. Internal governance aims at ensuring that an institution's management body (both the supervisory and management function) is explicitly and transparently responsible for its business strategy, organisation and internal control. Internal governance is the responsibility of the management body (both the supervisory and management function). It is concerned mainly with setting the institution's business objectives and its appetite for risk, how the business of the institution is organised, how responsibilities and authority are allocated, how reporting lines are set up and what information they convey, and how internal control (including risk control, compliance, and internal audit) is organised. The guidelines in Chapter 2 set out European supervisors' expectations for the internal governance of institutions. Some of the guidelines are specifically directed at the ICAAP, while others have a broader application.

The guidelines on internal governance in this document do not advocate any particular board structure. The term 'management body', which represents the top management level of an institution, is used in this document to embrace different structures, such as unitary and dual boards.

Within any institution, there are two key functions that must be fulfilled: supervision and management. Within Member States usually one of two corporate governance structures is used: a unitary or a dual board structure. Under a unitary board structure one body (e.g. the so-called board of directors) performs both the supervisory and management functions. Under a dual board structure the two functions are performed by more than one body.

In this document, when describing which functions within the management body we are referring to, this is mentioned in brackets. Reference is made to either the supervisory function, the management function, or both.

### ***ICAAP***

The ICAAP is codified in Article 123 of the [Directive 2006/48/EC](#). Within the institution's internal governance framework, the ICAAP is a process to ensure that the management body (both supervisory and management functions):

- Adequately identify, measure, aggregate and monitor the institution's risks.
- Hold adequate internal capital in relation to the institution's risk profile.
- Use sound risk management systems and develop them further.

It is the responsibility of the institution to define and develop its ICAAP. The onus is on the institution to demonstrate, during its dialogue with its supervisor, that its internal capital assessment is comprehensive and adequate to the nature of risks posed by its business activities and its operating environment. The framework under which an institution should develop its ICAAP is designed to be risk-based. The new framework emphasises the importance of capital planning, but also the importance of management, and other qualitative aspects of risk management. When assessing their capital needs, all institutions should be able to take into account the impact of economic cycles, and sensitivity to other external risks and factors. For larger and/or more complex institutions this may mean developing an appropriately detailed and rigorous stress and scenario testing framework.

Institutions have developed various methodologies for assessing their risk exposure and setting capital against it. The introduction of the ICAAP is not meant to suggest that existing methods, which have met the needs of institutions over the years, necessarily need to be replaced. However, all institutions should have adequate processes in place.

The ICAAP should be embedded in the institution's business and organisational processes, and not simply regarded as an add-on that permits the management body (both supervisory and management functions) to 'tick a box' and indicate that supervisory expectations nominally have been met.

### ***SREP***

The SREP is codified in Article 124 & Annex XI of the [Directive 2006/48/EC](#). In order to evaluate the ICAAP, including the adequacy of capital held by an institution, the supervisory authority must review the institution's exposure to all material risks (its risk profile), the adequacy and reliability of its internal governance and ICAAP, the adequacy of its own funds and the internal capital mitigants it has set against its risks. The supervisor must also assess whether capital is the correct means of addressing the institution's vulnerabilities.

The SREP should be structured with a view to ensuring consistency of treatment across institutions, keeping in mind that institutions differ in risk profile, strategy and management. Supervisors should have arrangements in place for the collection and verification of relevant information, and procedures to maintain the quality and consistency of risk assessments. An essential element of the SREP (and of the Risk Assessment System) is the ability to assess qualitatively each type of risk and its management, within the overall context of the institution's internal governance.

Supervisors assess the risk profile of an institution using a variety of sources (including statistical, desk-based analysis, on-site visits/inspections, and routine relationship management) as part of risk-based prudential supervision. These should provide the foundation for the supervisor to undertake (among other things) an evaluation of the institution's risk profile. They should also enable the supervisor to apply prudential measures over a period determined by the supervisor, and to maintain an accurate and up-to-date picture of the institution's risk profile in light of its progress in implementing prudential measures and/or other events which may have a significant impact on the risk assessment.

### ***RAS***

The RAS is the supervisor's tool for organising (i.e. planning, prioritising and allocating) the use of supervisory resources, and performing and managing the supervisory risk assessment. It provides structure and a practical step-by-step guide to the first phase of the SREP. It is therefore fundamentally a tool for internal supervisory purposes. The guidelines set out in this paper should lead to greater commonality of approach among authorities. This in turn should facilitate more effective communication between supervisors, especially between home and host competent authorities.

### ***ICAAP-SREP interaction***

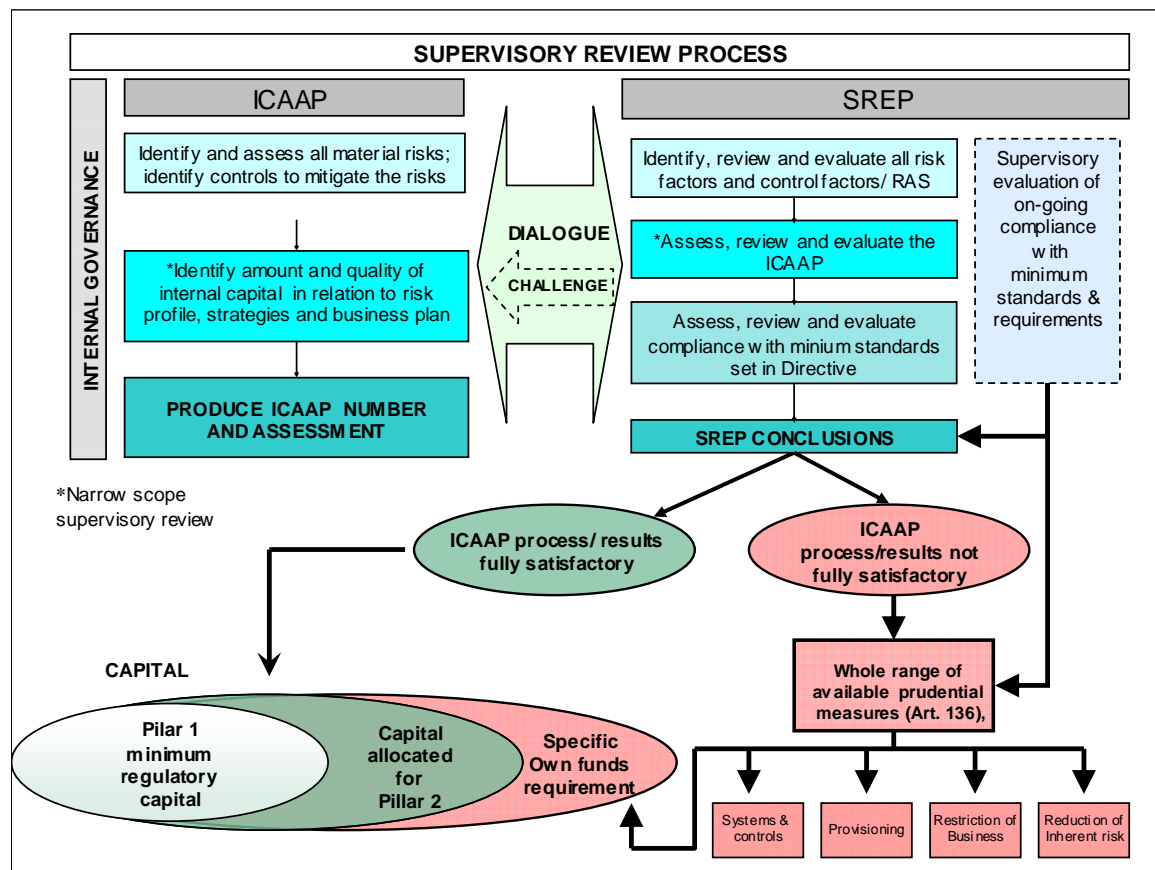
Supervisors will explore through the dialogue with institutions, how institutions set their risk strategy, how they identify, measure, aggregate

and monitor the risks they take, and how they set their overall risk-bearing capacity. The dialogue should be structured to cover elements such as internal governance (including risk controls, compliance, and internal audit), the organisation of the institution's business, and how the institution allocates capital against risk.

While the guidance on interaction and dialogue is directed mainly at supervisors, institutions will have a clear interest in knowing the approach supervisors intend to take

This process is illustrated in diagram 1.

**Diagram 1: the Supervisory Review Process**



### ***Key considerations***

Supervisors understand that the interaction of the ICAAP and SREP must be a balanced process, with each performing valuable functions and reinforcing the other.

### ***Proportionality***

It is important to note that the notion of proportionality, which is laid down both in the recitals and the provisions of the CRD, applies to all guidance contained in this paper. This means that guidance for both institutions and supervisors will be applied in a proportionate manner to reflect the nature, scale and complexity of the activities of the institutions.

Given the wide range of institutions to which CRD applies, and the need to apply these guidelines flexibly and proportionately, supervisors will be open to explanations from institutions as to how differing approaches would still meet the aims of the guidelines, i.e. there is no "one-size-which-fits-all" approach.

### ***Relation to Pillar 1***

The Pillar 1 capital requirement is based on uniform rules and is a minimum for own funds requirements. However, no set of uniform rules can capture all aspects of an institution's overall risk profile. For institutions and supervisors alike, judgements on risk and capital adequacy are based on the institution's overall risk profile, and therefore require more than a simple assessment of compliance with Pillar 1 minimum capital requirements.

Moreover, institutions are expected to operate above the minimum capital requirements set under Pillar 1. Requiring own funds over and above Pillar 1 requirements is one of several regulatory tools that can be used by supervisors in the supervisory review process to address identified risks, after fully and carefully considering other supervisory measures and other mitigating actions within the context of the overall quality of the institution's own risk management process.

It should also be noted that while institutions may refer to internal capital or economic capital in their ICAAPs, these differ in meaning and composition from own funds. To maximise clarity, supervisory authorities will focus on own funds in the ICAAP-SREP dialogue.

### ***Scope of application***

The scope of application of the SRP will be determined by reference to the CRD. For EU groups with authorised subsidiaries in other member states, the consolidating supervisor will undertake the SREP at group level, and each host supervisor will be entitled to undertake the SREP at subsidiary level (sub-consolidated as appropriate). It is recognised that in such circumstances co-operation between the individual Member State competent authorities needs to be significantly enhanced in order to avoid unnecessary duplication and regulatory burden.

To this end European authorities have committed themselves to observing a co-operative framework based on both close co-ordination and information sharing within operational networks so as to improve efficiency and effectiveness in the performance of supervisory tasks.

In accordance with [CEBS' guidelines on Home-Host](#) the key features of this co-operative framework can be summarised as follows:

- The consolidating supervisor will conduct the SREP for the group as a whole, assess the internal governance and the group ICAAP, have the dialogue with the key staff of the group, and draw conclusions from the SREP. The consolidating supervisor should initiate on a timely basis a process of consultation with the individual supervisors involved and take the lead in establishing co-operative arrangements based on the SREP.
- The host supervisor will perform the SREP at local level in order to assess internal governance and the ICAAP at subsidiary level (sub-consolidated as appropriate). In doing so the host supervisor will be able to take into account the dimension of the SREP/ICAAP at group level, within the context of the cooperative arrangements.
- The supervisory review will take into consideration the degree of integration of the banking group and its internal organisation. It is recognised that banking groups may be centralising certain activities such as their risk management functions and that consequently there may be a need to develop a more integrated and coordinated approach to supervision. In such cases the coordinating role of the consolidating supervisor will be more important, in view of the need to reach a coordinated and efficient supervisory review.
- The co-operative framework should contribute to enhancing the consistency of supervisory assessment throughout the whole group and should make clear which tasks are best carried out respectively by each supervisor. The consolidating supervisor may allocate, where appropriate, some tasks to the host supervisor. The host supervisor may also allocate some tasks to the consolidating supervisor or even delegate full supervision over subsidiaries in accordance with Article 131 of the Directive 2006/48/EC. The consolidating supervisor will take due account of the local SREP in the evaluation of the whole group.

## ▪ **Chapter 2. Guidance for institutions<sup>98</sup>**

This Chapter provides guidance on what supervisory authorities expect of institutions under the Pillar 2 framework. It sets out how an institution can comply with:

- Guidelines on Internal Governance.
- Guidelines on the ICAAP.

### **2.1 Guidelines on Internal Governance**

The purpose of this guidance on Internal Governance is not to establish new or additional requirements, but rather to assist supervisors in achieving greater consistency in their assessment of institutions' internal governance.

#### **A Corporate Structure and Organisation**

***IG 1: Institutions should have a corporate structure that is transparent and organised in a way that promotes and demonstrates the effective and prudent management of the institution both on a solo basis and at group level.***

The structure of an institution (and, where applicable, the structures and management lines of institutions within a group) should be clear and transparent both to the institution's own staff and to the relevant supervisory authorities. This is essential for supervisory oversight and for ensuring the effective and prudent management of the institution. Where appropriate, the supervisory authority may assess the legal organisation and the position of an institution within a group on a case-by-case basis.

***IG 2: The reporting lines and the allocation of responsibilities and authority within an institution should be clear, precise, well-defined, transparent, coherent, and enforced.***

a. There should be clear, precise and well-defined reporting lines and a clear and precise allocation of responsibilities and authority within an institution. Opaque or 'shadow' structures within an institution damage the ability of the management body (both supervisory and management functions) to conduct business in a prudent fashion.

b. The management body (both supervisory and management functions) should set and enforce clear lines of responsibility and authority within the institution. It is important that staff understand and adhere to policies and procedures concerning their authority and responsibilities. Staff receiving the information must be given adequate powers and authority to act.

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<sup>98</sup> The key components and considerations, including those on proportionality, apply to this chapter in full.

c. Internal reporting has a dual function: (i) it is used by the supervisory function as a tool for its oversight of the management function, and by the management function as a tool for its oversight of the entire institution; and (ii) staff use the information they receive from internal reports to carry out the responsibilities they have been given.

d. In cases where the business reporting lines do not match the legal structure of the institution or the group (e.g. operational structures where there is no coincidence between business areas and legal units), the management body (both supervisory and management functions) should ensure that areas of responsibility and authority are sufficiently clear and transparent. Reporting lines that deviate from the institution's legal structure could result from a matrix organisation, a functional organisation, or a geographically widespread organisation.

***IG 3: Institutions should ensure that the risk management function is organised in a way that facilitates the implementation of risk policies and the management of the institution's risks.***

a. The risk management function should be a central organisational feature of an institution. It should be structured in a way that permits it to achieve its objectives of implementing risk policies and managing risk within the institution. Large, complex and sophisticated institutions could consider establishing risk management functions to cover each material business line.

b. Risk management includes ongoing identification, measurement and assessment of all material risks that could adversely affect the achievement of the institution's goals. The procedures for risk monitoring and assessment need to be updated regularly. The management body (both supervisory and management functions) should set the risk strategy, the risk policy, and accordingly the risk-bearing capacity of the institution.

## **B The Management Body**

***IG 4: The responsibilities of the management body should be clearly defined in a written document. They should include setting the institution's business objectives, risk strategies and risk profile, and adopting the policies needed to achieve these objectives.***

a. These issues are the basis for the sound and prudent conduct of business, and should be decided at the level of the management body (both supervisory and management functions).

b. The management body (management function) is responsible for the implementation of the strategies and policies set by the management body (both supervisory and management functions). Written guidelines, manuals and other means that are deemed necessary should be used to facilitate the accurate implementation of the institution's overall objectives.

c. Documentation should include the essential duties and working procedures of the management body (both supervisory and management functions). These documents, along with the minutes of the meetings of the management body (both supervisory and management functions), should help the supervisor to evaluate the operation of the management body (both supervisory and management functions).

d. In the case of subsidiaries, the responsibilities of the management body (both supervisory and management functions) should acknowledge the business objectives, risk profile and policies defined by the management body of the parent institution. It should also be clearly stated in written documentation that the management body (both supervisory and management functions) in the subsidiary is responsible for the appropriate implementation of the strategies and policies set by the parent institution (including any input from minority interests where the subsidiary is not wholly owned) within the subsidiary consistent with their own local obligations.

***IG 5: The management body should ensure that strategies and policies are communicated to all relevant staff throughout the organisation.***

The management body (management function) should inform and update the staff concerning the institution's strategies and policies, at least to the level needed to carry out their particular duties. This may be done through written guidelines, manuals or other means. It is also important that the staff understand and adhere to policies and procedures pertaining to their duties and responsibilities.

***IG 6: The management body should systematically and regularly review the strategies and policies for managing the risks of the institution.***

a. Every institution should have effective processes for identifying, managing, monitoring and reporting the risks that it is exposed to. The management body (both supervisory and management functions) should ensure that the relevant strategies and policies are amended when necessary to reflect changing internal and external factors. This is particularly true for the macroeconomic environment in which the institution operates and the position in the business cycle.

b. Committees within the management body (supervisory function) may be set up to address risk management and audit if this facilitates the development and maintenance of good governance practices, as outlined above.

***IG 7: The management body should develop and maintain strong internal control systems.***

a. Strong internal control systems are essential to the ICAAP. The management body (both supervisory and management functions) is responsible for developing and maintaining systems to ensure effective and efficient operations, adequate control of risks, prudent conduct of business, reliability of financial and non-financial information reported or

disclosed both internally and externally, and compliance with laws, regulations and the institution's internal policies and procedures.

b. There are several instruments at the disposal of the management body (both supervisory and management functions) for maintaining a sufficiently high standard of internal control. These include the risk control function, the compliance function, and the internal audit function, all of which are described in the section on 'Internal Control' below.

***IG 8: The management body should ensure that internal control systems provide for adequate segregation of duties, in order to prevent conflicts of interest.***

In developing the internal control system, the management body (both supervisory and management functions), should ensure that there is a clear, transparent and documented decision-making process and a clear allocation of responsibilities and authority to ensure compliance with internal decisions and procedures. The internal control mechanisms should be adequate in relation to the business performed by the institution, and should constitute sound administrative and accounting procedures.

***IG 9: The management body should set effective strategies and policies to maintain, on an on-going basis, amounts, types and distribution of both internal capital and own funds adequate to cover the risks of the institution. (See ICAAP section for further details.)***

a. The management body (both supervisory and the management functions) should ensure that the institution's strategies and policies regarding both internal capital and own funds are both comprehensive and proportionate. Documentation should specify what types of own funds may be used (primary and supplementary capital). Furthermore, the distribution of own funds within a group must comply with legal requirements concerning the allocation of capital to subsidiaries.

b. For internal capital, the institution is free to use a different definition of capital from that used for regulatory purposes.

***IG 10: The management body should monitor and periodically assess the effectiveness of the institution's internal governance structure.***

a. At least once a year, the management body (both the supervisory and the management functions) should review and, if necessary, amend its policies for the internal governance structure of the institution. This frequency applies only to the internal governance issues covered by these guidelines. It does not transcend any legal obligations or recommendations concerning governance issues on the national level.

b. A review of the internal governance structure itself should also be performed annually. This review should focus on any changes in internal and external factors affecting the institution.

***IG 11: The management body should be active and independent, and should be able to explain its decisions to the supervisory authority and other interested parties.***

a. Notwithstanding their obligations towards other stakeholders as required under national law, the members of the management body (both supervisory and management functions) should be free to take decisions in the best interest of the institution. Their decisions should be clearly based on the information received and should take into account all relevant factors.

b. The members of the management body (both supervisory and management functions) should have the necessary expertise to carry out their duties, and should be able to make their own judgements and decisions.

c. While it is acknowledged that the management body (both supervisory and management functions) of a subsidiary is also expected to observe and implement the business objectives, risk profile and policies defined by the management body (both supervisory and management functions) of the parent institution, this has to be consistent with their own local obligations (including any in relation to minority interests where the subsidiary is not wholly owned).

***IG 12: The management body should have policies for selecting, compensating, monitoring and planning the succession of key executives.***

a. One of the primary tasks of the management body (both supervisory and management functions) is to ensure that the institution has, and will continue to have, qualified and experienced key executives.

b. The compensation schemes of the management body (both supervisory and management functions) should not be structured in a way that encourages unhealthy risk-taking or maximisation of short term profits.

***IG 13: The management body should promote high ethical and professional standards and an internal control culture.***

Implementing such standards throughout the institution should help reduce the risks to which it is exposed. For example, when the reputation of an institution is called into question, the loss of trust can be difficult to rebuild and can have repercussions throughout the market. In particular, operational risk will be reduced if these standards are given high priority. The management body (both supervisory and management functions) should therefore have clear policies for how these standards should be met, and they should perform a continuing review of their implementation.

## C Internal Control

***IG 14: Institutions should establish, making adequate allowance for the principle of proportionality, the following three primary functions in order to implement an effective and comprehensive system of internal control in all areas of the institution, namely (i) risk control function, (ii) compliance function, and (iii) internal audit function.***

a. These internal control functions should be independent of the business lines they monitor and control.

b. A control function can generally be regarded as independent if the following conditions are met:

- The control function staff does not perform any tasks that fall within the scope of the activities that the control function is intended to monitor and control.
- The control function is organisationally separate from the activities it is assigned to monitor and control. The head of the control function is subordinated to a person who has no responsibilities for managing the activities that are being monitored and controlled.
- The head of the control function reports directly to the management body (both supervisory and management functions) and/or the audit committee, and is present at least once a year at meetings of the body it reports to.
- The remuneration of the control function staff is not linked to the performance of the activities that the control function is intended to monitor and control.

c. These internal control functions (i.e. risk control, compliance and internal audit) should also be organisationally independent from each other, since they perform different functions. The reporting lines should run directly from the above-mentioned functions to the management body (both supervisory and management functions). Furthermore, it is the responsibility of the management body to ensure that the risk control function, the compliance function and the internal audit function all have sufficient resources (well-qualified and experienced staff, as well as a sufficient number of staff) at their disposal.

d. It may not be practical for smaller institutions to meet all of the above conditions; in such cases they may take other measures provided they can show how any real or potential conflicts of interest are avoided or mitigated.

***IG 15: The risk control function should ensure compliance with risk policies.***

a. Risk control requires an appropriate control structure. This should include the establishment of control policies and procedures as well as verification that the control policies and procedures are complied with. Control activities should be defined at the appropriate level.

b. The risk control function is designed to address the risks that the institution identifies through its risk assessment process. In large, complex and sophisticated institutions, a risk control function should be established to monitor each of the material risks to which the institution is exposed. The risk control function should report to the management body (both supervisory and management functions) and other relevant staff. The management body (management function) should continuously evaluate the risks affecting the achievement of its goals, and should react to changing circumstances and conditions.

***IG 16: The compliance function should identify and assess compliance risk.***

a. It is the responsibility of the management body (both supervisory and management functions) to approve the institution's policy with regards to compliance risk. Compliance risk is defined as the risk of legal or regulatory sanctions, material financial loss, or loss to reputation an institution may suffer as a result of its failure to comply with compliance laws, rules and standards.

b. In order to fulfil this responsibility the management body (management function) should establish and communicate a compliance policy, ensure that it is observed, and report to the management body (supervisory function) on the management of the compliance risk by the institution. Furthermore, the management function should establish a permanent and effective compliance function.

c. The compliance function should advise the management function on compliance laws, rules and standards, including keeping them informed on developments in the area. The compliance function can also assess the possible impact of any changes in the legal environment on the operations of the institution. The compliance function also has the role of verifying that new products and new procedures are in compliance with the current legal environment and any known amendments to the legislation that has not yet entered into force.

d. In less-complex and smaller institutions the tasks of the compliance function may be performed by the risk control function or internal audit.

***IG 17: The internal audit function should allow the management body to ensure that the quality of the internal controls is both effective and efficient.***

a. The management body (both supervisory and management functions) is responsible for establishing the internal control framework in compliance with regulatory requirements. The internal audit function is responsible for the assessment of the adequacy of internal controls and should report its findings to the management body (both supervisory and management functions)

b. The internal audit function should have unfettered access to the management body (both supervisory and management functions) and/or

to the audit committee where applicable. Any suggestions by internal audit for material improvements in internal controls should be reported directly to the management body (both supervisory and management functions). All audit recommendations should be subject to a formal follow-up procedure by the respective level of management, in order to ensure (and report) their resolution.

c. The internal audit function should evaluate the adequacy of the internal control framework of the institution (including the risk control and compliance functions) and report its findings. It should also have unfettered access to relevant documents and information in all business lines. It should evaluate the compliance of all activities and divisions with the institution's policies and procedures. The internal audit function must also evaluate whether existing policies and procedures remain adequate.

***IG 18: There should be effective internal control systems and reliable information systems covering all significant activities of the institution.***

a. A critical component of an institution's activities is the establishment and maintenance of management information systems that cover the full range of its activities. This information is typically provided through both electronic and non-electronic means. Institutions must be particularly aware of the organisational and internal control requirements related to processing information in an electronic form, and of the necessity to have an adequate audit trail. Management decision-making could be adversely affected by unreliable or misleading information provided by systems that are poorly designed and controlled.

b. Information systems, including those that hold and use data in electronic form, must be secure, independently monitored and supported by adequate contingency arrangements.

***IG 19: The management body should put in place appropriate internal alert procedures for communicating internal governance concerns from the staff.***

a. Institutions are encouraged to adopt appropriate internal alert procedures that staff can use to draw attention to significant and legitimate concerns regarding matters connected with internal governance. These procedures should respect the confidentiality of the staff who raise such concerns. There should be an opportunity to raise these kinds of concerns outside regular reporting lines (e.g. to the head of compliance or internal auditor). The procedures on how to make their concerns known should be made available in writing to all staff within the institution. Information provided by the staff through the alert procedure should, if relevant, be made available to the management body (both supervisory and management functions).

b. In some Member States, in addition to any internal alert procedures within the institution, there may also be a possibility for staff to inform the supervisory authority of their concerns of this type.

## **D Public Disclosure and Transparency**

### ***IG 20: Institutions should meet the generally agreed transparency requirements in the conduct of their business.***

a. For major institutions, the expectations of investors, customers, rating agencies and others may require a higher degree of transparency.

b. Public disclosure is desirable in the following areas: the structure of the management body (both supervisory and management functions), basic organisational structure, the incentive/remuneration structure of the institution and the nature and extent of transactions with affiliates and related parties. Such disclosures enable interested parties to form a true and accurate assessment of the institution.

c. Institutions may also find it desirable to describe how their risk management, risk control, compliance and internal audit functions are organised. Finally, they may want to outline the major tasks performed by these functions, describe how performance is monitored by the management body (both supervisory and management functions), and describe how any necessary improvements are being implemented.

### ***IG 21: Each institution should present its current position and future prospects in a balanced, accurate and timely way.***

a. Information about the current position of the institution should comply with any legal requirements regarding the disclosure of such information. The information should be accurate, relevant, timely and accessible, in order to meet the needs of supervisors, investors, customers, clients, rating agencies, External Credit Assessment Institutions (ECAIs), and the public.

b. In cases where ensuring a high degree of accuracy would delay the release of time-sensitive information, the institution should make a judgement as to the appropriate balance between timeliness and accuracy, bearing in mind the requirement to provide a true and fair picture of the institution's situation. This reasoning should not be used to delay regular reporting requirements, and a satisfactory explanation of the circumstances warranting an exception should be provided.

c. Disclosures should include, but not be limited to, material information on the financial and operating results of the company, foreseeable risk factors and governance structures and policies.

## **2.2 Guidelines on ICAAP<sup>99</sup>**

This Chapter provides guidelines on what supervisory authorities expect of institutions under ICAAP.

### ***ICAAP 1: Every institution must have a process for assessing its capital adequacy relative to its risk profile (an ICAAP).***

Every institution must have an ICAAP. The scope of application of the ICAAP will be determined by reference to the CRD.

### ***ICAAP 2: The ICAAP is the responsibility of the institution.***

a. Each institution is responsible for its ICAAP, and for setting internal capital targets that are consistent with its risk profile and operating environment. The ICAAP should be tailored to the institution's circumstances and needs, and it should use the inputs and definitions that the institution normally uses for internal purposes.

b. At the same time, the institution should be able to demonstrate how the ICAAP meets supervisory requirements.

c. Without prejudice to [ICAAP 4](#), any outsourcing of portions of the ICAAP must meet CEBS' Guidelines on outsourcing. Institutions retain full responsibility for their ICAAP regardless of the degree of outsourcing, and they should understand that outsourcing does not relieve them of the need to ensure that their ICAAP fully reflects their specific situation and individual risk profile.

### ***ICAAP 3: The ICAAP's design should be fully specified, the institution's capital policy should be fully documented, and the management body (both supervisory and management functions) should take responsibility for the ICAAP.***

a. The responsibility for initiating and designing the ICAAP rests with the management body (both supervisory and management functions). The supervisory function within the management body should approve the conceptual design (at a minimum, the scope, general methodology and objectives) of the ICAAP. The details of the design (i.e. the technical concepts) are the responsibility of the management function.

b. The management body (both supervisory and management functions) is also responsible for integrating capital planning and capital management into the institution's overall risk-management culture and approach. They should ensure that capital planning and management policies and procedures are communicated and implemented institution-wide and supported by sufficient authority and resources.

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<sup>99</sup> The key components and considerations, including those on proportionality, apply to this chapter in full

c. The institution's ICAAP (i.e. the methodologies, assumptions and procedures) and capital policy should be formally documented, and it should be reviewed and approved at the top level (management body in the sense of both functions) of the institution.

d. The results of the ICAAP should be reported to the management body (both supervisory and management functions).

***ICAAP 4: The ICAAP should form an integral part of the management process and decision-making culture of the institution.***

a. The ICAAP should form an integral part of institutions' management processes so as to enable the management body (both supervisory and management functions) to assess, on an ongoing basis, the risks that are inherent in their activities and material to the institution. This could range from using the ICAAP to allocate capital to business units, to having it play a role in the individual credit decision process, to having it play a role in more general business decisions (e.g. expansion plans) and budgets.

***ICAAP 5: The ICAAP should be reviewed regularly.***

a. The ICAAP should be reviewed by the institution as often as is deemed necessary to ensure that risks are covered adequately and that capital coverage reflects the actual risk profile of the institution. This review should take place at least annually.

b. The ICAAP and its review process should be subject to independent internal review.

c. Any changes in the institution's strategic focus, business plan, operating environment or other factors that materially affect assumptions or methodologies used in the ICAAP should initiate appropriate adjustments to the ICAAP. New risks that occur in the business of the institution should be identified and incorporated into the ICAAP.

***ICAAP 6: The ICAAP should be risk-based.***

a. The adequacy of an institution's capital is a function of its risk profile. Institutions should set capital targets which are consistent with their risk profile and operating environment.

b. Institutions may take other considerations into account in deciding how much capital to hold, such as external rating goals, market reputation and strategic goals.

c. However, if other considerations are included in the process, the institution must be able to show in its dialogue with its supervisor how they influenced its decisions concerning the amount of capital to hold.

d. There are some types of (less readily quantifiable) risks for which the focus of the ICAAP should be more qualitative assessment, risk management and mitigation. The institution should clearly establish for

which risks a quantitative measure is warranted, and for which risks a qualitative measure is the correct risk mitigation tool.

e. Institutions that take a Pillar 1 approach as the starting point for their ICAAP (see below) may also consider developing a fully risk-based approach, as the Capital Requirements Directive promotes a risk-based approach (including the Standardised Approach for credit risk), and because general management and control frameworks will increasingly be risk-based.

***ICAAP 7: The ICAAP should be comprehensive.***

a. The ICAAP should capture all the material risks to which the institution is exposed, albeit that there is no standard categorisation of risk types and definition of materiality. The institution is free to use its own terminology and definitions, albeit that it should be able to explain these in detail to the supervisor, including the methods used, the coverage of all material risks and how its approach relates to its obligations under Pillar 1 (for example, if the institution uses for the purposes of ICAAP a definition of operational risk that differs from the definition in Pillar 1, or a definition of interest rate risk that included both banking book and trading book risk).

b. The ICAAP should cover:

- Pillar 1 risks, including major differences between the treatment of Pillar 1 risks in the calculation of own funds requirements and their treatment under the ICAAP.
- Risks not fully captured under Pillar 1. Risks which fall into this category could include underestimation of credit risk using the standardised approach, underestimation of operational risk using the basic indicator approach or standardised approach, and for stressed loss given default (LGDs). Specifically, regarding credit risk, the following should be taken into account, for example, residual risk in credit risk mitigation (CRM), and securitisation.
- Pillar 2 risks. The ICAAP should cover all material Pillar 2 risks to which the institution may be exposed, such as interest rate risk in the banking book, concentration risk, liquidity risk, reputation and strategic risk. Some of these risks are less likely to lend themselves to quantitative approaches, in which cases institutions are expected to employ more qualitative methods of assessment and mitigation.
- Risk factors external to the institution. These include risks which may arise from the regulatory, economic or business environment and which are not included in the above mentioned risks.

***ICAAP 8: The ICAAP should be forward-looking.***

a. The ICAAP should take into account the institution's strategic plans and how they relate to macro-economic factors. The institution should develop an internal strategy for maintaining capital levels which can incorporate factors such as loan growth expectations, future sources and uses of

funds and dividend policy, and any procyclical variation of Pillar 1 minimum own funds requirements.

b. The institution should have an explicit, approved capital plan which states the institution's objectives and the time horizon for achieving those objectives, and in broad terms the capital planning process and the responsibilities for that process. The plan should also lay out how the institution will comply with capital requirements in the future, any relevant limits related to capital, and a general contingency plan for dealing with divergences and unexpected events (for example, raising additional capital, restricting business, or using risk mitigation techniques).

c. Institutions should conduct appropriate stress tests which take into account, for example, the risks specific to the jurisdiction(s) in which they operate and the particular stage of the business cycle. Institutions should analyse the impact that new legislation, the actions of competitors or other factors may have on their performance, in order to determine what changes in the environment they could sustain.

***ICAAP 9: The ICAAP should be based on adequate measurement and assessment processes.***

a. Institutions should have a documented process for assessing risks. This process may operate either at the level of the individual institution, or at group level.

b. The results and findings of the ICAAP should feed into an institution's evaluation of its strategy and risk appetite. For less sophisticated institutions in particular, for which genuine strategic capital planning is likely to be more difficult, the results of the process should mainly influence the institution's management of its risk profile (for example, via changes to its lending behaviour or through the use of risk mitigants).

c. Institutions will not be required to use formal economic capital (or other) models, although it is expected that more sophisticated institutions will elect to do so.

d. There is no single 'correct' process. Depending on proportionality considerations and the development of practices over time, institutions may design their ICAAP in different ways. For example, the ICAAP may use:

- The result produced by the regulatory Pillar 1 methodologies (which are themselves risk-based) and consideration of non-Pillar 1 elements. In other words, to obtain a capital goal, institutions may take the Pillar 1 requirements and then assess Pillar 2 concepts that relate to Pillar 1 (such as concentration risk, residual risk of CRM and securitisation) and concepts that are not dealt with under Pillar 1 (such as interest rate risk). The Pillar 1 approach may be appropriate for some institutions, although they would have to take an active role in justifying this choice, including consideration of forward-looking elements. Supervisors would expect the institution to demonstrate that it had analysed all risks outside Pillar 1 and found them to be absent,

not material, or covered by a simple cushion over the Pillar 1 minimum.

- A 'structured' approach, using different methodologies for the different risk types (Pillar 1 and Pillar 2 risks) and then calculating a simple sum of the resulting capital requirements. This is explored in more detail in chapter 4.
- A more sophisticated and complex system, possibly using 'bottom-up' transaction-based approaches with integrated correlations.

e. Institutions are likely to find that some risks are easier to measure than others, depending on the availability of information. This implies that their ICAAPs could be a mixture of detailed calculations and estimates.

f. It is also important that institutions not rely on quantitative methods alone to assess their capital adequacy, but include an element of qualitative assessment and management judgement of inputs and outputs. Considerations such as external rating goals, market reputation and strategic goals should be taken into account in all three methodologies.

g. Non-quantifiable risks should be included if they are material, even if they can only be estimated. This requirement might be eased if the institution can demonstrate that it has an appropriate policy for mitigating/managing these risks.

***ICAAP 10: The ICAAP should produce a reasonable outcome.***

a. The ICAAP should produce a reasonable overall capital number and assessment. The institution should be able to explain to the supervisor's satisfaction the similarities and differences between its ICAAP (which should cover all material risks) and its own funds requirements.

b. Institutions might be encouraged to make greater disclosures of information which is not proprietary or confidential. This may provide them a means for comparing their ICAAP with their peer group, for internal purposes.

## Chapter 3. Guidance for Supervisory Authorities<sup>100</sup>

This Chapter provides guidelines on SREP and RAS.

### **3.1 Guidelines on SREP**

***SREP 1: The SREP should be an integrated part of the authority's overall risk-based approach to supervision.***

a. The evaluation process will be an integral, explicit and formal part of the authority's overall supervisory approach.

b. The evaluation process underpins the supervisor's dialogue with the institution (and does not replicate the role of the institution's management).

c. It is recognised that different supervisory authorities will use different types of evaluation processes. For example, there will be differences in the emphasis on qualitative versus quantitative judgements and the degree of automation within a system.

d. However, European supervisory authorities agree that while flexibility of approach is important, common minimum standards are needed in order to ensure consistency of application and a level playing field across Europe.

***SREP 2: The SREP should apply to all authorised institutions.***

The scope of application of the SREP will be determined by reference to the CRD.

***SREP 3: The SREP should cover all the activities of an institution.***

a. All significant business units of the institution, whether operating domestically or overseas, will be considered in the evaluation process.

b. Other risks to the consolidated group will also be captured, for example where services such as IT, accounting, or payment and settlement functions are being provided or control functions are being exercised from outside the consolidated group on an outsourced basis (even if within the wider group).

***SREP 4: The SREP should cover all material risks and internal governance.***

a. The supervisory authority will formally evaluate the institution's business risks and internal governance (including risk controls, compliance, and internal audit).

b. The evaluation will focus on identifying each institution's risk profile and assessing the quality of the institution's risk management system. The business risks covered should span all activities and all significant business units. The evaluation of controls should include, at a minimum,

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<sup>100</sup> The key components and considerations, including those on proportionality, apply to this chapter in full.

an assessment of the quality of internal governance, management body, organisational structure, the risk management and control environment and internal audit and compliance functions. Supervisors should review the controls that have been put in place to mitigate risk, as well as the adequacy and composition of capital held against those risks.

c. The evaluation should be forward-looking in the sense that it should consider, based on information known at the time, whether the risk profile of the institution is likely to change over the forthcoming period.

d. The supervisor can use stress tests to help determine the need for early intervention.

e. Both qualitative and quantitative assessments for specific risks will require more elaborate and precise guidance, which will be laid out in future papers.

***SREP 5: The SREP will assess and review the institution's ICAAP.***

The supervisor will assess the institution's ICAAP as part of its SREP. This should include a consideration of the assumptions, components, methodology, coverage and outcome of the institution's ICAAP. This review should cover both the institution's risk-management processes and its assessment of adequate capital. Supervisors should review the controls in place to mitigate risk, as well as the adequacy and composition of capital held against those risks. This is laid out in more detail in chapter 4.

***SREP 6: The SREP will assess and review the institution's compliance with the requirements laid down in the CRD.***

As part of the SREP, the supervisor must also evaluate the institution's compliance with the various minimum requirements under the CRD. For instance, in addition to the ICAAP requirements, these include an evaluation of the methods and models used in advanced approaches under Pillar 1, large exposures and an evaluation of disclosure under Pillar 3.

***SREP 7: The SREP should identify existing or potential problems and key risks faced by the institution and deficiencies in its control and risk management frameworks; and it should assess the degree of reliance that can be placed on the outputs of the institution's ICAAP.***

This process will enable the supervisory authority to tailor its approach to the individual institution, provide the foundation for the supervisor's general approach to the institution and its actions, and encourage institutions to improve their risk management systems.

***SREP 8: The SREP will inform supervisors about the need to apply prudential measures.***

Once it has evaluated the adequacy of an institution's capital in relation to its risk profile, the supervisor should identify any prudential measures or other supervisory actions required. For example, where there is an imbalance between business and risk controls, the supervisor should

consider the range of remedial supervisory actions that may be needed to rectify a deficiency in controls and/or perceived shortfalls in capital, either as a long-term requirement(s) or as a short-term action(s). This is laid out in more detail in chapter 4.

***SREP 9: The results of the SREP will be communicated to the institution at the appropriate level (usually the management body in the sense of management function) together with any action that is required of the institution and any significant action planned by the supervisory authority.***

a. The authority will convey the results of its risk assessment to the institution. This may be done as part of the dialogue between the authority and the institution on the internal systems used to assess capital adequacy, which is described in more detail in chapter 4.

b. This review and evaluation allows the supervisor, among other things, to provide qualitative feedback to the institution about the adequacy of its risk management and internal controls in relation to its business risk profile, and to assess and understand the extent to which the output of the ICAAP can serve as an input to the SREP.

***SREP 10: The supervisory evaluation should be formally reviewed at least on an annual basis, to ensure that it is up-to-date and remains accurate.***

a. Supervisory authorities agree that this review may not always constitute a full risk assessment.

b. However, supervisory authorities should at least take stock of any significant changes to the overall risk profile over the past year. They will take into account the results of any supervisory visits, inspections and other information received during the period, and will consider whether the timing of the next full assessment, as agreed during the previous full assessment process, remains appropriate.

c. Notwithstanding the above, any significant new information received in the course of ongoing monitoring and supervision which may affect the institution's risk profile will trigger consideration by the authority of the need for a formal review or a full risk assessment.

## **RAS**

The RAS is the supervisor's tool for organising (i.e. planning, prioritising and allocating) the use of supervisory resources, and performing and managing the supervisory risk assessment. It is intended to provide structure and a practical step-by-step guide to the first phase of the SREP.

### **3.2 Guidelines on RAS<sup>101</sup>**

***RAS 1: In order to carry out an overall assessment of an institution, the supervisory authority should define guidelines covering both risks and controls.***

a. The overall assessment of the risks and controls should be done in a way that facilitates the allocation of resources to those institutions (or those areas within institutions) that require the most attention. Supervisory authorities should have individual ratings for risks and controls.

b. The guidelines for integration (or aggregation) may be based upon the following key principles:

- High risks are assigned a relatively higher weight than low risks.
- Weak controls are assigned a relatively higher weight than strong controls.
- Risks are assigned a relatively higher weight than controls, reflecting the fact that requirements for controls should increase as the level of inherent risk rises.

c. Given the different approaches used in different countries, the resulting overall assessment may not arrive at the same scoring or rating of risks and controls.

d. It may be useful to set a default score or rating for particular risks within business units of institutions. In certain circumstances, for example where there is insufficient information to set a score or rating at the outset, the supervisory authority may wish to set a conservative or high default score or rating and then correct it in the light of further analysis.

***RAS 2: In order to assess an institution's risks and controls, the supervisor needs to prepare a breakdown of the institution's activities, down to the material business units or processes where risks are actually taken and where to a large extent controls are actually applied.***

a. Supervisory authorities need to formulate rules for the breakdown process, taking into account the need to identify the various business elements under supervision for planning purposes. This implies that the level of detail of the breakdown needs to be geared to the level of detail of the planning process.

b. The starting point is a general description of the institution. To facilitate the detection, assessment and aggregation of risks and the quality of the controls, the institution can be broken down into significant business units or processes.

c. This breakdown is especially useful for groups and major institutions. It may be simpler for smaller institutions.

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<sup>101</sup> The key components and considerations, including those on proportionality, apply to this chapter in full.

d. This process can be structured as follows (the basic process will be the same for large and small institutions, but it will of course be more complex for larger entities):

- Identification of all business units or processes, using the institution's organisation chart as a starting point. Two types of business units or processes can be distinguished: (i) business lines (e.g. mortgages, treasury, credit cards) and (ii) management functions (e.g. centralised departments such as ALM, risk-management, internal audit, internal control).
- Identification of centralised group functions to facilitate the assessment of group-wide risks and controls, such as overall strategic risk, quality of the members of the management body (both supervisory and management functions), reporting lines at the highest level, and centralised management functions (e.g. risk management, internal audit and internal control).
- Determination of the significance (materiality) of each unit or process using both quantitative (e.g. contribution to earnings, profit or capital requirement) and qualitative criteria.
- Assessment of the relative impact of the business units or processes on the overall assessment of risks and controls in the light of the issues raised in the previous bullets.
- While this breakdown is important, particularly for the consolidating supervisor, an individual-entity approach is also very important for effective communication between home and host competent authorities when a group has cross-border subsidiaries. An individual-entity approach is also important for the dialogue between supervisors and institutions concerning the appropriate distribution of capital within a group. Keeping an individual-entity approach in mind will help to ensure that the distribution of capital remains appropriate: i.e. that the allocation of capital remains commensurate with the distribution of risks, so that each institution, including the parent, has the appropriate amount of capital relative to its risks in each country, and sufficient leeway for growth.

e. The supervisor should select the relevant risk categories it would like to include in the assessment, as not all risk categories may be applicable or relevant to each business unit or process.

f. In the final step of the breakdown process, the supervisor decides whether to perform a full-scale expert assessment or a simplified, less detailed assessment. In the latter case, scores or ratings could be assigned directly, at a more aggregated level. This decision should take into account the balance between workload and value-added. In jurisdictions with a large number of smaller institutions, the use of default scores or ratings may be considered.

***RAS 3: A Risk Assessment System should encompass all relevant risks and internal governance factors, while at the same time making a clear distinction between the two.***

To support the comparability of different Risk Assessment Systems, and given the needs of cross-border cooperation and information-sharing, all supervisory authorities should take into account the full set of risks and principles elaborated in this paper.

***RAS 4: In order to make the results of all risk assessments comparable, both between the various institutions within a country and between countries, the results of the supervisory authorities' risk assessments should be based on an assessment of both quantitative and qualitative information.***

a. The core of the Risk Assessment System is the assessment of the risk profile and the quality of the controls of the institution under supervision. This assessment should cover all significant business units and processes. The rating system preferably should be designed to discourage the tendency to assign average risk scores or controls to groups of institutions. Each risk and control category should be sub-divided into its underlying determinants (for example, credit risk may consist of three items: default probability, concentration and correlation, and recovery rate). The rating system may also cover the quality of the loan portfolio and the amount of provisions.

b. These determinants should be rated by means of a qualitative assessment, which may be expressed in a (quantitative) score or rating. Quantitative information, as well as qualitative information, is necessary to provide key insights to certain risks, and should be used to form the overall qualitative and quantitative assessment.

c. Supervisors may wish to lay out, by way of public disclosure, the criteria underlying each score or rating class, in order to:

- Explain the overall system.
- Assist in understanding the risks of a particular institution.
- Allow better comparisons between different national systems.

d. In addition to the knowledge and professional judgement of the individual supervisors regarding the supervised institutions, supervisors can draw upon a broad range of information sources to help them assess the risks and mitigating controls of institutions. These include:

- Information available in supervisory examination reports, including information available from on-site inspections.
- Mandatory financial reporting by supervised institutions (for example, information on credit risk provided in reports on large exposures, country risk exposures, total provisions, non-performing loans, doubtful loans, etc.).
- Information from reporting by supervised institutions in compliance with other regulatory requirements.

- Interviews (and minutes of these interviews) with senior personnel and staff of supervised institutions.
  - Internal management reports of the supervised institution, which can be made available on request (e.g. profit and loss account, balance sheet, strategy and policy papers and budgets).
  - Internal minutes of various management and committee meetings (e.g. Management Board, ALCO, credit committee).
  - The internal and external audit reports of the supervised institution.
- e. Supervisory Authorities may wish to develop an IT-tool to support the risk assessment method. This may facilitate the assessment of risks and controls and improve its efficiency. It may also help standardise systems and facilitate comparisons and transfers of information between supervisors within the same country, or between countries. An IT-tool may also provide a useful audit trail.

***RAS 5: Procedures for quality assurance should be in place in order to maintain the quality and consistency of risk assessments.***

a. Quality assurance is one of the key elements in the overall risk assessment process. It maintains the quality and consistency of assessment results, and may consist of the following elements:

- An adequate challenge process, including a regular review of the global risk assessment process. One possible way of structuring this review in some countries might be to submit the results of the risk assessment to a quality assurance panel consisting of experienced supervisors.
- A regular review of individual assessments. Consistency and comparability can be ensured by having a minimum of two supervisors perform the various steps in the risk analysis (the 'four eyes' principle).
- The risk assessment process may be supported by a dedicated team. It may support the supervisors during the assessments, communicate with the management body and international authorities, further develop the risk assessment methodology and software tools, and maintain the risk assessment manual.
- A traceable rating history or audit trail, so that changes in the assessment can be traced back to the responsible supervisor.

***RAS 6: The supervisory authority should compare the results of the RAS with the outcome of the ICAAP and analyse their consistency.***

The RAS does not constitute a parallel or secondary ICAAP or a benchmark for an institution's own processes. However, if an institution's ICAAP is judged to be inadequate, the RAS should be able to assist the supervisory authority in determining, in general terms, the overall risk profile of the institution, and may provide an indication of the capital needed to cover all the risks.

## Chapter 4: The SREP-ICAAP interaction and prudential measures<sup>102</sup>

### 4.1 Guidelines on the dialogue

#### ***Dialogue 1: Supervisors should have a methodology to structure the dialogue with the institution.***

- a. A key element of the SREP is the dialogue between supervisors and institutions. It will inform the supervisor about the way the institution's ICAAP is structured, the assumptions which are used to determine underlying risks across different sectors and risk types, risk sensitivity and confidence levels, and how risks are aggregated.
- b. The supervisory assessment should be based on a review of the institution's ICAAP. The SREP is not intended to perform a parallel recalculation (although some form of independent calculation may be necessary in cases where an institution's ICAAP is so flawed that the supervisor decides it cannot be relied upon to form the basis for the dialogue).
- c. It would be inappropriate for the supervisor to enter into the ICAAP-SREP dialogue with pre-conceived ideas as to whether the capital held by the institution adequately covers all material risks. It is up to the institution to justify its process for identifying and measuring its risks and then justify how much capital, if any, it allocates against them, taking into account other qualitative mitigants of risk.
- d. The institution should be able to explain any differences between its own assessment of capital needs and targets under the ICAAP and own funds requirements.

#### ***Dialogue 2: The structure of the dialogue should comprise four main elements.***

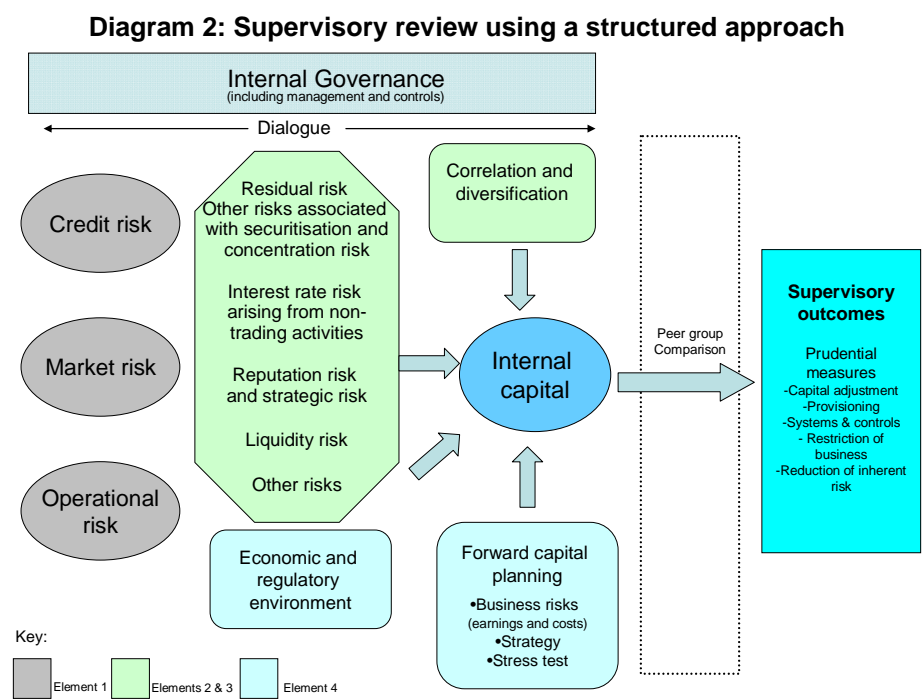
- a. The dialogue should embrace the following four elements:
  - Element 1: Pillar 1 risks (credit, market, and operational risk).
  - Element 2: Risks not fully captured under Pillar 1 (for example, residual risk in CRM, and securitisation risk).
  - Element 3: Risks covered by Pillar 2 (for example, interest rate risk in the banking book, concentration risk, liquidity risk, settlement risk, reputation risk, strategic risk). Under credit risk, element 3 would include underestimation of credit risk using standardised approaches and weaknesses in credit risk mitigation.
  - Element 4: External factors, where not already considered in the previous points, including stress-testing in IRB, impact of economic cycles and other external risks and factors.

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<sup>102</sup> The key components and considerations, including those on proportionality, apply to this chapter in full.

b. These four elements, as well as the quality of internal governance (including risk controls, compliance and internal audit, as well as operational and organisational structure) of the institution, are illustrated in Diagram 2. Further guidance will be provided in due course on the content of some of these individual risk elements.

c. It is important to stress that these elements **should not be interpreted as resulting in automatic capital add-ons**. Supervisors will apply judgement when considering the relationship between qualitative and quantitative components, making due allowance for qualitative measures which may be effective mitigants on their own or in combination with capital. Moreover, it is not a question of simply aggregating risks and the capital which may be attributed to them. There may be good reasons why the total amount of capital allocated may be less than the sum of the individual risk elements; however these would need to be assessed within the context of a holistic approach which would have to be sufficiently robust.



***Dialogue 3: Supervisors should use the dialogue to test and challenge the institutions' ICAAP and to exchange views, in order to reach a better understanding of the underlying assumptions and processes.***

a. For this process to be effective, supervisors need to have a sufficiently thorough understanding of how the ICAAP is determined and the differences between it and Pillar 1. This should also help them evaluate the ICAAP outcome. This process emphasises the importance of analysing the main elements, understanding the differences between ICAAP

assumptions and Pillar 1 assumptions, and understanding the extent to which the institution has introduced diversification and correlation effects.

b. As is the case with current supervisory practice, the supervisor may use the results of the RAS and a mix of on-site and off-site inspection to increase its understanding of the institution's ICAAP.

c. The institution may make changes to the ICAAP in the course of the dialogue, in response to challenge and feedback from the supervisor. Following the dialogue, the supervisor will reach an assessment.

***Dialogue 4: The frequency and depth of the dialogue will be determined by the supervisor, according to its assessment of the risk profile and/or systemic importance of each institution.***

a. It is up to the supervisory authority - not the institution - to determine when the dialogue should start and how intensive it will be. The supervisory authority will also determine the nature and depth of the dialogue, based on the type of institution and its peer-group ranking.

b. Once the process has begun, the dialogue will provide the opportunity for iteration between the ICAAP and SREP, with each informing the other.

c. Although the intensity of the dialogue will vary both between and within peer groups of institutions (reflecting the nature of the peer group and the levels of concern, based on risk assessment), supervisors will establish basic benchmarks for the intensity of supervisory resources that will be needed for each peer group. Supervisors will then be expected to scale up from these benchmarks for those institutions which are assessed as posing greater risk.<sup>103</sup>

d. For larger and more sophisticated institutions, the dialogue is likely to be tailored to fit their particular needs. For smaller, less sophisticated institutions – for whom a detailed dialogue may not be necessary – more standardised guidance may be provided on the Pillar 2 components; but such guidance by the supervisor should not be allowed to develop into *de facto* regulation.

e. For institutions that intend to apply for advanced approaches, the approval processes for credit, operational and market risks can help to identify any relevant aspects of the individual institution's methods which may have Pillar 2 implications (including system and control factors). Supervisors may wish to develop a similar approach to identifying those elements of standard approaches which are open to a degree of interpretation or provide scope for regulatory arbitrage.

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<sup>103</sup> The tool of peer-group comparison is not available at the cross-border level. But it would seem desirable to hold regular confidential discussions between supervisors, in order to promote convergence, comparability and consistency and to ensure a level playing field in the supervision of large international groups.

## **4.2 Guidelines on prudential measures<sup>104</sup>**

***Measures 1: Prudential measures - to address issues identified either through the SREP or as part of ongoing supervision - should be applied promptly.***

a. If the supervisor considers that an institution's ICAAP does not adequately reflect its overall risk profile, or does not result in the institution having adequate capital, then consideration should be given to applying prudential measures.

b. The measures available to the supervisory authorities include:

- Requiring an institution to hold own funds and/or Tier 1 capital above the minimum level required by Pillar 1, and/or imposing other limitations on own funds.
- Requiring the institution to improve its internal control and risk management frameworks.
- Requiring the institution to apply a specific provisioning policy or treatment of assets in terms of own funds requirements
- Restricting or limiting the business, operations or network of the institution.
- Requiring the institution to reduce the risk inherent in its activities, products and systems.

c. The range of envisaged supervisory measures should be identified as one output of the SREP. The final decision on which measures to implement will be taken by the supervisor, taking into account the outcome of the dialogue with the institution.

d. The choice of prudential measures should be determined according to the severity and underlying causes of the situation and the range of measures and sanctions available to the supervisor. Measures can be used individually or in combination. A specific own funds requirement should, however, be imposed on any institution which exhibits an imbalance between its business risks and its internal control and risk frameworks, if that imbalance cannot be remedied by other prudential measures or supervisory actions within an appropriate timeframe.

e. A specific own funds requirement may also be set where the supervisor judges the level of own funds held by an institution to be inherently inadequate for its overall risk profile. It must be acknowledged that there is no 'scientific' method for determining the amount, and that capital is not a long-run substitute for remedying deficiencies in systems and controls. In practice, the process relies heavily on subjective judgement and peer-group consistency to ensure a level playing field and a defence to challenge by institutions.

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<sup>104</sup> The key components and considerations, including those on proportionality, apply to this chapter in full.

f. A balanced view of all available supervisory measures (as set out in Article 136 of the [Directive 2006/48/EC](#)) is essential as an outcome of the process.

***Measures 2: Prudential measures should be communicated promptly and in sufficient detail.***

a. In communicating its decision on prudential measures, the supervisory authority should:

- Explain in sufficient detail the factors which have led to the risk assessment conclusions.
- Indicate areas of weakness and the timeframe for remedial action.
- Explain the reasons for any adjustment to the institution's capital requirements.
- Indicate what improvements could be made to systems and controls to make them adequate for the risks and activities of the institution, and for this improvement to be reflected in the institution's capital requirements.

b. It is recognised that the relationship between the supervisory authority and the institution's external auditors varies from country to country and that, depending on the various countries, it may not be appropriate for supervisors to communicate the results of their assessment to the external auditors or to discuss it with them.

## **Annex 1: Definitions and acronyms**

### ***Internal governance***

In these guidelines, the term 'internal governance' is used, as opposed to the term 'corporate governance.' While corporate governance has a wider scope and includes issues that concern the shareholders and other stakeholders of an institution, internal governance focuses on the responsibility of management body (both supervisory and management functions). It is mainly concerned with setting the institution's business objectives and its appetite for risk, how the business of the institution is organised, how responsibilities and authority are allocated, how reporting lines are set up and what information they convey, and how internal control (including risk control, compliance, and internal audit) is organised.

### ***Institutions***

Credit institutions and investment firms as defined in the CRD.

### ***Internal Control***

The management body is responsible for ensuring that the institution has in place the three independent functions that constitute an efficient system of internal control. These functions are risk control, compliance and internal audit. The risk control function ensures that risk policies are complied with. The compliance function identifies and assesses compliance risk. The internal audit function is an instrument for the management body to ensure that the quality of the risk control function and the compliance function is adequate. Internal control also includes, e.g. accounting organisation, treatment of information, risk assessment and measurement systems.

### ***Risks***

For the purposes of this paper, the risks faced by institutions are defined as follows:

**Business risks:** consists amongst others of credit risk, market risk, interest rate risk, liquidity risk, operational risk, strategic risk, and reputation risk.

**Concentration risk:** as part of credit risk, concentration risk includes (i) large (connected) individual exposures and (ii) significant exposures to groups of counterparts whose likelihood of default is driven by common underlying factors, e.g. sector, economy, geographical location, instrument type.

**Credit risk:** the current or prospective risk to earnings and capital arising from an obligor's failure to meet the terms of any contract with the institution or its failure to perform as agreed. This risk includes residual risk, the credit risk in securitisation and cross-border (or transfer) risk.

**Interest rate risk:** the current or prospective risk to earnings and capital arising from adverse movements in interest rates.

**IT risk:** sub-category of operational risk: the current or prospective risk to earnings and capital arising from inadequate information technology and processing in terms of manageability, exclusivity, integrity, controllability and continuity, or arising from an inadequate IT strategy and policy or from inadequate use of the institution's information technology.

**Legal and compliance risk:** sub-category of operational risk: the current or prospective risk to earnings and capital arising from violations or non-compliance with laws, rules, regulations, agreements, prescribed practices, or ethical standards.

**Liquidity risk:** the current or prospective risk to earnings and capital arising from an institution's inability to meet its liabilities when they come due.

**Market risk:** the current or prospective risk to earnings and capital arising from adverse movements in bond prices, security or commodity prices or foreign exchange rates in the trading book. This risk can arise from market-making, dealing, and position-taking in bonds, securities, currencies, commodities, or derivatives (on bonds, securities, currencies, or commodities). This risk includes foreign exchange risk, defined as the current or prospective risk to earnings and capital arising from adverse movements in currency exchange rates.

**Operational risk:** the risk of loss resulting from inadequate or failed internal processes, people and systems or from external events. This risk includes IT, legal and compliance risk.

**Reputation risk:** the current or prospective risk to earnings and capital arising from adverse perception of the image of the financial institution on the part of customers, counterparties, shareholders, investors or regulators.

**Residual risk:** sub-category of credit risk: the risk that recognized risk measurement and mitigation techniques used by the credit institution prove less effective than expected.

**Settlement Risk:** The risk, that the credit institution will deliver the sold asset or cash to the counterparty and will not receive the purchased asset or cash as expected. As such a settlement risk comprises credit risk and liquidity risk.

**Strategic risk:** the current or prospective risk to earnings and capital arising from changes in the business environment and from adverse business decisions, improper implementation of decisions or lack of responsiveness to changes in the business environment.

**Annex 2: Summary of the guidelines on the supervisory review process**

CEBS role and task

Lamfalussy Framework

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1.2.....Objectives

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**2. Cooperation procedures, approval and post-approval process**

**3. Supervisor’s assessment of the application concerning the minimum requirements of the CRD – Credit Risk**

Data for economic loss

Use of external data of economic loss

Discount rate

Allocation of direct and indirect costs

2. 240. The third parameter used in the supervisory formula for calculating regulatory capital requirements is Exposure Value. However, the CRD requires that the parameter to be estimated is the Conversion Factor (CF).

High level principles

Definitions

Time horizon

Supervisory conversion factors versus own estimates

Data

Risk Drivers

404.....The CRD co

management processes and measurement systems shall be subject to regular reviews performed by internal and/or external auditors.” These reviews could be performed either by the institution’s internal unit or by an external auditor. As the external auditor may also be involved in performing the

institution's statutory audit, the question of independence arises.

#### Principles and examples

##### Internal data

461e. The execution of models for generating regulatory operational risk figures should be supported by a transparent and consistent process. Depending on the modelling methodology chosen, institutions could take the following steps which are to be intended neither exhaustive nor binding:

1. Preliminary identification of a set of probability distributions to be fitted to the data.

461m. General examples of methods that institutions could use to obtain a sufficient amount of data reflecting the current operational risk profile include the following:

461n In the absence of sufficient data, institutions should make conservative risk estimates.

Competent authorities shall verify that individual credit assessments are accessible at equivalent terms at least to all credit institutions having a legitimate interest in these individual credit assessments.

#### Executive Summary

Principal aims of Pillar 2

#### Chapter 1: Introduction

Key Components

SRP

Internal Governance

ICAAP

SREP

RAS

ICAAP-SREP interaction

Key considerations

Proportionality

Relation to Pillar 1

Scope of application

#### 2.1 Guidelines on Internal Governance

IG 1: Institutions should have a corporate structure that is transparent and organised in a way that promotes and demonstrates the effective and prudent management of the institution both on a solo basis and at group level.

IG 2: The reporting lines and the allocation of responsibilities and authority within an institution should be clear, precise, well-defined, transparent, coherent, and enforced.

IG 3: Institutions should ensure that the risk management function is organised in a way that facilitates the implementation of risk policies and the management of the institution's risks.

IG 4: The responsibilities of the management body should be clearly defined in a written document. They should include setting the institution's business objectives, risk strategies and risk profile, and adopting the policies needed to achieve these objectives.

IG 5: The management body should ensure that strategies and policies are communicated to all relevant staff throughout the organisation.

IG 6: The management body should systematically and regularly review the strategies and policies for managing the risks of the institution.

IG 7: The management body should develop and maintain strong internal control systems.

IG 8: The management body should ensure that internal control systems provide for adequate segregation of duties, in order to prevent conflicts of interest.

IG 9: The management body should set effective strategies and policies to maintain, on an on-going basis, amounts, types and distribution of both internal capital and own funds adequate to cover the risks of the institution. (See ICAAP section for further details.)

IG 10: The management body should monitor and periodically assess the effectiveness of the institution's internal governance structure.

IG 11: The management body should be active and independent, and should be able to explain its decisions to the supervisory authority and other interested parties.

IG 12: The management body should have policies for selecting, compensating, monitoring and planning the succession of key executives.

IG 13: The management body should promote high ethical and professional standards and an internal control culture.

IG 14: Institutions should establish, making adequate allowance for the principle of proportionality, the following three primary functions in order to implement an effective and comprehensive system of internal control in all areas of the institution, namely (i) risk control function, (ii) compliance function, and (iii) internal audit function.

IG 15: The risk control function should ensure compliance with risk policies.

IG 16: The compliance function should identify and assess compliance risk.

IG 18: There should be effective internal control systems and reliable information systems covering all significant activities of the institution.

IG 19: The management body should put in place appropriate internal alert procedures for communicating internal governance concerns from the staff.

IG 20: Institutions should meet the generally agreed transparency requirements in the conduct of their business.

IG 21: Each institution should present its current position and future prospects in a balanced, accurate and timely way.

## 2.2 Guidelines on ICAAP

ICAAP 1: Every institution must have a process for assessing its capital adequacy relative to its risk profile (an ICAAP).

ICAAP 2: The ICAAP is the responsibility of the institution.

ICAAP 3: The ICAAP's design should be fully specified, the institution's capital policy should be fully documented, and the management body (both supervisory and management functions) should take responsibility for the ICAAP.

ICAAP 4: The ICAAP should form an integral part of the management process and decision-making culture of the institution.

ICAAP 5: The ICAAP should be reviewed regularly.

ICAAP 6: The ICAAP should be risk-based.

ICAAP 7: The ICAAP should be comprehensive.

ICAAP 8: The ICAAP should be forward-looking.

ICAAP 9: The ICAAP should be based on adequate measurement and assessment processes.

ICAAP 10: The ICAAP should produce a reasonable outcome.

## Chapter 3. Guidance for Supervisory Authorities

### 3.1 Guidelines on SREP

SREP 1: The SREP should be an integrated part of the authority's overall risk-based approach to supervision.

SREP 2: The SREP should apply to all authorised institutions. The scope of application of the SREP will be determined by reference to the CRD.

SREP 3: The SREP should cover all the activities of an institution.

SREP 4: The SREP should cover all material risks and internal governance.

SREP 5: The SREP will assess and review the institution's ICAAP.

SREP 6: The SREP will assess and review the institution's compliance with the requirements laid down in the CRD.

SREP 7: The SREP should identify existing or potential problems and key risks faced by the institution and deficiencies in its control and risk management frameworks; and it should assess the degree of reliance that can be placed on the outputs of the institution's ICAAP.

SREP 8: The SREP will inform supervisors about the need to apply prudential measures.

SREP 9: The results of the SREP will be communicated to the institution at the appropriate level (usually the management body in the sense of management function) together with any action that is required of the institution and any significant action planned by the supervisory authority.

SREP 10: The supervisory evaluation should be formally reviewed at least on an annual basis, to ensure that it is up-to-date and remains accurate.

### 3.2 Guidelines on RAS

RAS 1: In order to carry out an overall assessment of an institution, the supervisory authority should define guidelines covering both risks and controls.

RAS 2: In order to assess an institution's risks and controls, the supervisor needs to prepare a breakdown of the institution's activities, down to the material business units or processes where risks are actually taken and where to a large extent controls are actually applied.

RAS 3: A Risk Assessment System should encompass all relevant risks and internal governance factors, while at the same time making a clear distinction between the two.

RAS 4: In order to make the results of all risk assessments comparable, both between the various institutions within a country and between countries, the results of the supervisory authorities' risk assessments should be based on an assessment of both quantitative and qualitative information.

RAS 5: Procedures for quality assurance should be in place in order to maintain the quality and consistency of risk assessments.

RAS 6: The supervisory authority should compare the results of the RAS with the outcome of the ICAAP and analyse their consistency.

#### Chapter 4: The SREP-ICAAP interaction and prudential measures

##### 4.1 Guidelines on the dialogue

Dialogue 1: Supervisors should have a methodology to structure the dialogue with the institution.

Dialogue 2: The structure of the dialogue should comprise four main elements.

Dialogue 3: Supervisors should use the dialogue to test and challenge the institutions' ICAAP and to exchange views, in order to reach a better understanding of the underlying assumptions and processes.

Dialogue 4: The frequency and depth of the dialogue will be determined by the supervisor, according to its assessment of the risk profile and/or systemic importance of each institution.

##### 4.2 Guidelines on prudential measures

Measures 1: Prudential measures - to address issues identified either through the SREP or as part of ongoing supervision - should be applied promptly.

Measures 2: Prudential measures should be communicated promptly and in sufficient detail.

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## Additional technical guidance on the Application of the Supervisory Review Process under the CRD (IRRBB, Concentration Risk and Stress Testing)

### 5.2.1 Technical aspects of the management of interest rate risk arising from non-trading activities under the supervisory review process<sup>105</sup>

#### Executive Summary

1. CEBS refers in its [Guidelines on the Application of the Supervisory Review Process under Pillar 2](#) to a structured dialogue between supervisors and institutions that should embrace four types of risks (i) Pillar 1 risks, (ii) risks not fully captured under Pillar 1, (iii) risks covered by Pillar 2 and (iv) external factors not already considered in the previous cases<sup>106</sup>.
2. In particular, institutions should develop and maintain an ICAAP that identifies risks they are, or might be exposed to and allocate adequate financial resources against those risks.
3. This paper sets out technical guidelines applicable to one of those risks: “interest rate risk arising from non-trading activities” (here, “interest rate risk in the banking book” or “IRRBB”), as a follow-up to CEBS Guidelines on the Supervisory Review Process.
4. The document puts the emphasis on high-level guidance, some of which is addressed to institutions (both credit institutions and investment firms) and some to supervisors. It is not meant to provide detailed guidance on whether and how quantitative tools and models should be used or developed. The responsibility for this must rest with the institutions, though supervisors will expect to see institutions develop their own systems and stress tests which are commensurate with their risk profile and risk management policies.
5. It sets out general considerations including current international thinking, a definition of what the IRRBB should cover, the relevant legal requirements of the Directive 2006/48/EC, and a summary of current market practices. This, together with the supervisory

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<sup>105</sup> As to the history of this guidelines on the technical aspects of the management of interest rate risk arising from non-trading activities under the supervisory review process, the documents is on the CEBS website under the following link: [http://www.c-ebs.org/documents/EGB-Other/guidelines\\_IRRBB\\_000.aspx](http://www.c-ebs.org/documents/EGB-Other/guidelines_IRRBB_000.aspx)

<sup>106</sup> See Chapter 4: the SREP-ICAAP interaction and prudential measures. Dialogue 2.

considerations, explains the context that has led to the guidelines. It is recognised that market practices and supervisory approaches may evolve over time, and therefore there is a need to ensure that such a technical paper is kept under review and, to the extent necessary, adapted to reflect any such developments.

6. The concept of proportionality, as laid down in the provisions of the Directive 2006/48/EC related to Pillar 2 and underlined in the introductory statements of CEBS' guidelines on the application of the supervisory review process, applies also to IRRBB measurement and management, the complexity of which will be expected to be related to the size of the institutions as well as to the sophistication and diversification of their activities.

7. The paper then sets out:

guidance on what the supervisors should expect to see in the ICAAP<sup>107</sup>, under which it is the institution's own responsibility to manage adequately (i.e. identify, measure, monitor and control) these risks and allocate internal capital, where considered necessary, in support of the interest rate risk in a structured manner, the corresponding guidance to supervisors in conducting the Supervisory Review and Evaluation Process (SREP) in relation to the ICAAP. Supervisors will require institutions to show that their internal capital, where considered necessary, is commensurate with the level of the interest rate risk in the banking book. In doing so, and in accordance with CEBS guidelines on the Application of the Supervisory Review Process under Pillar 2, the supervisory authorities will adapt their approach to ensure it is proportionate to the nature, scale and complexity of the activities of an institution. Similarly, the depth, frequency and intensity of the supervisory evaluation will be determined by the risks posed to the supervisor's statutory objective of ensuring the soundness of the banking sector.

8. In relation to non-trading activities, the [Directive 2006/48/EC](#) requires under Article 124(5) that measures shall be taken by supervisory authorities in cases where an institution's economic value declines by more than 20% of own funds as a result of a standard shock. As the Directive 2006/48/EC does not define what that 'standard shock' should be, CEBS proposes a common definition. This is intended to achieve a common standard which supervisors can apply consistently across the EU, thereby delivering a level playing field.

9. This would enable banking groups operating on a cross border basis to calculate the standard shock required by the Directive 2006/48/EC in a comparable way. If necessary, national supervisors can set a shock of a different magnitude than the one derived by the calculation method of IRRBB 5. In the context of the CEBS guidelines on supervisory cooperation for cross-border banking and investment firm groups

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<sup>107</sup> "ICAAP stands for Internal Capital Adequacy" Process

(GL09), Coordination and dialogue under the aegis of the consolidating supervisor through operational networking will be crucial to ensure that commonality over time.

10. CEBS nevertheless acknowledges the 'broad brush' nature of a standard shock and recognises that, as part of their dialogue with individual institutions, supervisors may require their institutions to apply routinely shocks of a different order of magnitude, both in amount and time, reflecting the nature, size and complexity of those institutions.
11. The draft guidelines went through a three-month public consultation as the first part of the 11<sup>th</sup> Consultation paper of CEBS.
12. Overall, although respondents welcomed the CEBS efforts to provide guidelines in these aspects, they raised concerns on the level of details and prescriptiveness of the guidelines. CEBS has addressed these comments by clarifying the proposed guidelines and readjusting the level of prescriptiveness.
13. Attached to this paper is a feedback table which contains a summary of the key points arising from the consultation and the responses made to address them. It includes an annex reflecting CEBS' views on the detailed comments received.

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**Appendix I:** Basel Committee on Banking Supervision- Supporting Document - [Principles for the Management and Supervision of Interest Rate Risk, July 2004.](#)

**Appendix II :** Basel Committee on Banking Supervision- Principles for the Management and Supervision of Interest Rate Risk, Annex 4 - An example of a standardized framework July 2004.

### General considerations

1. The measurement of interest rate risk in the banking book in a non-mark-to-market world poses a number of major practical difficulties. Most of these difficulties are dealt with by institutions making certain assumptions which may differ between institutions and which may be modified over time even within one institution. Hence interest rate risk in the banking book is part of Pillar 2 where a tailored approach is possible.
2. Some issues, such as the consequences of IFRS for the reporting and management of interest rate risk, have not been captured in the present document but may be the subject of further work by CEBS in due course.
3. Under the IFRS framework, the fair value option in IAS 39 will allow institutions to fair-value banking book items. Although the effect of the change is still not clear, it is likely that institutions will increase the use of fair value – rather than historical cost – for the measurement of a number of financial assets (including derivatives) held in the banking book, and eventually some of their liabilities. IFRS additionally asks institutions to perform and disclose a sensitivity analysis for each of the market risks to which they are exposed, including the interest rate risk on financial instruments. The disclosure could take a number of forms such as a maturity-repricing schedule. Financial risk management policies and objectives must also be disclosed. There will clearly be some differences with the regulatory framework for interest rate risk in the banking book, because the

objectives of prudential regulation and IFRS, and some of the definitions used, will not be the same in all cases.

### **International context**

4. Interest rate risk in the banking book forms part of the Basel Committee on Banking Supervision's revised framework on "[International Convergence of Capital Measurement and Capital Standards \(June 2004\)](#)" ('the Basel text'). In particular Section III, paragraphs 761-764, which were complemented by a Supporting Document to the Capital Adequacy Framework, deal with interest rate risk (in both the banking and the trading book) ("Principles for the Management and Supervision of Interest Rate Risk", July 2004). These documents have been used as a sound basis for this paper. Guidance on qualitative aspects of the management and measurement of risks has been set out in the CEBS guidelines on the application of the supervisory review process under Pillar 2, (Chapter 2.1. Guidelines on Internal Governance). These guidelines apply naturally to the IRRBB risk. Overall, it has been ensured that this paper is consistent with current international thinking.

### **Definition**

5. For the purpose of this paper, interest rate risk is taken to be the current or prospective risk to both the earnings and capital of institutions arising from adverse movements in interest rates. In the context of Pillar 2, this is in respect of the banking book only, given that interest rate risk in the trading book is already covered under the Pillar 1 market risk regulations.
6. Consideration of interest rate risk from the perspectives of both short-term earnings and economic value is important. Volatility of earnings is an important focal point for interest rate analysis because significantly reduced earnings can pose a threat to capital adequacy. However, measurement of the impact on economic value (the present value of the bank's expected net cash flows) provides a more comprehensive view of the potential long-term effects on an institution's overall exposures. Therefore, the supervisory focus will primarily be on measuring interest rate risk in relation to economic value. However, and subject to proportionality considerations, institutions are also expected to consider interest rate risk in relation to earnings as a supplementary measure.

### **Legal Basis**

7. In the Directive 2006/48/EC, interest rate risk in the non-trading book is treated under the ICAAP/SREP framework. Similar to other Pillar 2 risks, the Directive 2006/48/EC requires that:

- an institution shall implement systems to evaluate and manage the risk arising from potential changes in interest rates as they affect a credit institution's non-trading activities (Annex V. para. 11)<sup>108</sup>,
  - credit institution shall have in place sound, effective and complete strategies and processes to assess and maintain on an on-going basis the amounts, types and distribution of internal capital that they consider adequate to cover the nature and level of the risks to which they are or might be exposed (Article 123), and
  - competent authorities have to review risk management processes and capital adequacy (Article 124).
8. In contrast to other Pillar 2 risks however, Article 124(5) places on the supervisor the specific obligation to take action in cases where the economic value of an institution declines by more than 20% of own funds as a result of applying a supervisory standard shock to its interest rate risk in the non-trading book.

### **Current market practices**

#### **(i) Identification of IRRBB**

9. There are numerous ways that financial institutions currently identify and measure IRRBB. Their methods reflect the specific form of the risk in question and the nature, scale and complexity of their activities. IRRBB encompasses:
- a. risks related to the timing mismatch in the maturity and repricing of assets and liabilities and off balance sheet short and long term positions (repricing risk),
  - b. risk arising from changes in the slope and the shape of the yield curve (yield curve risk),
  - c. risks arising from hedging exposure to one interest rate with exposure to a rate which reprices under slightly different conditions (basis risk), and
  - d. risks arising from options, including embedded options, e.g. consumers redeeming fixed rate products when market rates change (i.e. option risk)

#### **(ii) Monitoring and management of IRRBB**

10. A wide range of tools may be used by institutions to measure and monitor IRRBB. The choice of monitoring system and management technique used is determined by the banks' management to be

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<sup>108</sup> Article 22 deals with governance arrangements. Annex V sets out technical criteria on organisation and treatment of risks under the heading "Interest rate risk arising from non-trading activities".

most appropriate depending on the nature, scale and complexity of their business. Institutions are usually using:

- a. systems which track the progress of transactions, based on which institutions estimate the pipeline risks<sup>109</sup>,
  - b. gap analysis showing the assets and liabilities at the different repricing dates, and the sensitivity of the present value of these buckets to different scenarios in interest rates, and
  - c. simulation techniques using scenarios that calculate the impact of changes in market conditions, e.g. the different repricing instruments, simulation of interest rate paths, customer behaviours etc.
11. Furthermore, stress testing can also be performed, in order to measure financial institutions' vulnerability under stressed market conditions like abrupt changes in the level and slope of the term structure of interest rates, changes in the relationships among key market rates, etc.<sup>110</sup>
12. When using gap analysis and/or simulation techniques, institutions measure the IRRBB under different shifts of the term structure of interest rate (parallel shifts and yield curve twists).
13. Based on these various tools, institutions use different types of hedges to mitigate the risks, or use limits – usually on earnings and/or economic value. Some institutions set aside capital buffers.
14. The management body sets out the IRRBB policy. Although the specific organisation established to put into effect the IRRBB policy may vary, in large or more complex institutions, measuring, monitoring and controlling IRRBB is usually vested in a "Asset and Liability Management" (ALM) function. It is usually assigned to an independent risk control unit. Some institutions also have a committee with powers delegated by the board, usually called "Asset and Liability Committee" (ALCO), responsible for major interest rate risk hedging and new asset and liability decisions.
15. Supervisors recognise that there are various levels of centralisation of ALM within institutions, e.g. in cross border groups some may have a centralised management and assessment function for IRRBB while others do not.

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<sup>109</sup> A pipeline risk would occur for instance when a tranche of fixed-rate mortgages still to be sold where the corresponding interest swap has already been executed

<sup>110</sup> Further guidance on this issue is provided in the CEBS Guidelines on Stress Testing.

### **(iii) Variables monitored in the IRRBB process**

16. Institutions usually consider two different, but complementary, perspectives in their process of assessing IRRBB.
17. The earnings perspective focuses on the sensitivity of earnings in the short-term to interest rate movements. Institutions usually adopt this perspective due to two main reasons: (i) this is the variable through which an interest rate change has an immediate impact on reported earnings; and (ii) the assessment of interest rate risk from an economic value perspective is difficult because it is mainly based on assumptions about the behaviour of long-term instruments, such as stable demand deposits or other non-interest bearing balance sheet items and those with embedded options.
18. The economic value perspective focuses on the sensitivity of the economic values of the banking book items to interest rate changes. Some institutions may use this approach as the shorter term earnings perspective will not completely capture the impact of interest rate movement on the market value of long term positions.

### **Supervisory considerations**

19. A number of considerations arise from the above
  - risk assessment should be done within the scope of the SRP process, be it at a consolidated, sub-consolidated or solo level. When it comes to cross-border groups, the cooperation between home and host supervisors will take into consideration the level and the manner in which the IRR management is performed by the institutions.
  - As it has not been standard practice to require additional own funds (regulatory capital) for interest rate risk in the banking book, supervisors will need to develop their approaches to the use of this prudential measure, where considered necessary,
  - incentives must be in place, as appropriate, for the development and application of advanced models and techniques,
  - the level playing field should be disturbed as little as possible in terms of maintaining a consistent and fair approach,
  - the administrative burden should not be excessive,
  - the supervisory policy on interest rate risk and any information obtained under that policy should be

complementary to aggregate financial stability analyses across institutions, and

- because the non-trading books of investment firms are usually (relatively) small, IRRBB guidelines are primarily relevant for the credit institutions. Consideration should be given to the absolute or relative size of the non-trading activities, in a way comparable to the Pillar 1 market risk regulation for interest rate risk in the trading book, with a view to implement these guidelines in a proportionate manner.

20. The concept of proportionality, as laid down in the provisions of the Directive 2006/48/EC related to Pillar 2 and underlined in the introductory statements of CEBS' guidelines on the application of the supervisory review process, applies also to IRRBB measurement and management, the complexity of which will be expected to be related to the size of the institutions as well as to the sophistication and diversification of their activities.

21. There are arguments both for and against standardised reporting of interest rate risk in the banking book, as well as for and against the possible middle ground of standardised reporting applied to less complex institutions and non-standardised reporting applied to complex institutions. This paper expresses no preferences in this respect.

22. Nonetheless, and in the context of Articles 123 and 124(5), institutions should at least be able to compute and report the effects of the standard shock described in IRRBB 2 and 5 on economic value as well as the amount of internal capital set aside, where considered necessary, for interest rate risk in the banking book. As noted in paragraph 6, and subject to proportionality considerations, institutions are also expected to consider interest rate risk against earnings, and should therefore consider the effect of instantaneous or gradual interest rate changes on short-term earnings. The results of such analysis may be requested, as additional information, by national supervisors.

23. Whichever approach to reporting is employed, supervisors should collect sufficient information about internal methodologies and underlying assumptions of institutions (e.g. yield curves used, internal measurement of positions without contractual maturity, treatment of optionality etc) for them to evaluate the reported information and to make their own assessment of the adequacy of the results of interest rate risk measurement.

24. As it is currently the case, off-site supervision can take place on the basis of institutions' internal reports and/or following some standardised, supervisory format. Supervisors can also undertake on-site inspections.

## Guidance for institutions

### ***IRRBB1***

**Institutions should be able to demonstrate that their internal capital is commensurate with the level of the interest rate risk in their banking book. In that respect, institutions should be able to calculate the:**

- **potential changes in their economic value resulting from changes in the levels of interest rates.** It is the responsibility of the institutions to develop and use their own methodologies in accordance with their risk profile and risk management policies. Supervisors may however reserve the right to require institutions to apply an additional standardised methodology, when for example the institution's internal methodology is inadequate or does not exist. An example of such a methodology is provided by the standardised framework of Annex 4 of the supporting Basel document "Principles for the management and supervision of interest rate risk"- See Appendix II, and
- **the overall interest rate risk in the banking book** at various levels of consolidation, sub-consolidation and solo entity if required to do so by supervisors.

### ***IRRBB 2***

**Institutions must be able to compute and report to their supervisory authority the change in their economic value as a result of applying a standard shock prescribed by the authority in the context of Article 124(5) (see IRRBB 5 below).**

If as a result of this standard shock an institution's economic value were to decline by more than 20% of own funds it should be prepared to discuss with the supervisory authority measures which might need to be taken to mitigate such a potential decline.

### ***IRRBB 3***

**Besides the standard shock, institutions should be able to measure their exposure, if material, and sensitivity to changes in the shape of the yield curve, changes between different market rates (i.e. basis risk) and changes to assumptions, for example those about customer behaviour.**

Institutions should also consider whether a purely static analysis of the impact on their current portfolio of a given shock or shocks should be supplemented by a more dynamic simulation

approach. Larger and/or more complex institutions should also take into account scenarios where different interest rate paths are computed and where some of the assumptions (e.g. about behaviour, contribution to risk and balance sheet size and composition) are themselves functions of interest rate levels.

#### ***IRRBB 4***

#### **Institutions should have a well reasoned, robust and documented policy to address all issues that are important to their individual circumstances.**

Without prejudice to the principle of proportionality, examples of such issues include:

- The internal definition and boundary between “banking book” / “trading activities”.
- The definition of economic value and its consistency with the method used to value assets and liabilities (for example based on the discounted value of future cash flows, on the discounted value of future earnings).
- The size and the form of the different shocks to be used for internal calculations.
- The use of a dynamic and / or static approach in the application of interest rate shocks.
- The treatment of commonly called “pipeline transactions” (including any related hedging).
- The aggregation of multicurrency interest rate exposures.
- The treatment of basis risk resulting from different interest rate indexes
- The inclusion (or not) of non-interest bearing assets and liabilities of the banking book (including capital and reserves)
- The treatment of current and savings accounts (i.e. the maturity attached to exposures without a contractual maturity).
- The appropriate consideration of embedded options in assets or liabilities.
- The extent to which sensitivities to small shocks can be scaled up linearly without material loss of accuracy (i.e. covering both convexity generally and the non-linearity of pay-off associated with explicit option products).

- The degree of granularity employed (e.g. offsets within a time bucket)
- Whether all future cash flows or only principal balances are included.

## **Guidance for supervisors**

### ***IRRBB 5***

**Supervisory authorities will set a comparable standard shock as referred to in Article 124(5) of the [Directive 2006/48/EC](#) and applicable to the non-trading book of all their relevant institutions. Supervisors may decide to set different standard shocks for different currencies. The following guidelines will be put in place:**

- A standard shock could, for example, be set so that it will be broadly equivalent to the 1st and 99th percentile of observed interest rate changes (five years of observed one day movements scaled up to a 240 day year), This would currently equate approximately to a parallel 200 basis points shock for major currencies - as suggested by the Basel Committee (See Appendix II below).
- National supervisors will be expected to use this as their starting point when considering at what level to set the shock, but they will also need to take into account factors such as the general level of interest rates, the shape of the yield curve and any relevant national characteristics in their financial systems
- National supervisors will periodically review the size of the shocks in the light of changing circumstances, in particular the general level of interest rates (for instance periods of very low interest rates) and their volatility. Institutions' internal systems should therefore be flexible enough to compute their sensitivity to any standardised shock that is prescribed. Supervisors will not, however, make frequent or minor amendments for the purpose of spurious statistical accuracy.
- National competent authorities commit to discuss periodically the relevance of the 200 basis points as a starting point when considering at what level to set the shock and keep it under review in light of implementation.
- If the required shock (e.g. a 200 basis point shock) would imply negative interest rates or if such a shock would otherwise be considered inappropriate, the national supervisor will adjust the requirements accordingly, and

- Where an institution is a subsidiary of an institution which is authorised in another EU member state, the respective supervisors will, in accordance with the CEBS guidelines on supervisory cooperation for cross-border banking and investment firm groups, seek to coordinate their approaches on the standard shocks to be applied.

### ***IRRBB 6***

**The supervisory review should encompass both the qualitative and organisational aspects of interest rate risk management, an evaluation of the institution's quantification of interest rate risk and an assessment of the adequacy of the relationship between interest rate risk and internal capital.**

This approach will be tailored to an institution's specific risk profile, drawing on the Basel Supporting Document "Principles for the Management and Supervision of Interest Rate Risk"-See Appendix I below-.

### ***IRRBB 7***

**The scope of application of the supervisors' assessment of interest rate risk is that used for the Supervisory Review Process(SRP)<sup>111</sup>.**

Where necessary for the fulfilment of their statutory objectives, for instance where there are obstacles to cash movements among subsidiaries or separate management processes among subsidiaries, supervisors will have the discretion to apply assessments at the level of individual entities.

### ***IRRBB 8***

**Supervisors should understand the institutions' internal method for calculating the IRR in the banking book, including underlying assumptions (e.g. yield curves used, treatment of optionality).**

This will include allowing for supervisors to have an in-depth analysis and assessments of institutions' internal methods (including institutions' assumptions underlying the issues raised in IRRBB 4 above). This could form the basis for peer group analysis and/or (model) benchmarking, and offer the supervisor a handle for discussions with the institution. Institutions may

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<sup>111</sup> The Scope of application of the SRP is set out in the introduction of the CEBS guidelines on the Application of the Supervisory review Process under Pillar 2: <http://www.c-eps.org/documents/Publications/Standards---Guidelines/files-from-old-website/GL03.aspx>

be requested to calculate the effects of specific, ad hoc interest rate scenarios.

### ***IRRBB 9***

**Prompt prudential measures, including both qualitative and quantitative elements tailored to an institution's specific circumstances, may be required from either the overall supervisory assessment or, as stated in Article 124(5), in response to an institution reporting that its economic value may decline by more than 20% of own funds as a result of applying the supervisory standard shock.**

Supervisors should take into account not only the decline on the economic value but also the current level of the economic value.

The range of possible supervisory measures could be but are not limited to:

- improvement of risk management arrangements,
- variations to internal limits,
- reduction of the risk profile, and
- increase in the amount of required regulatory capital.

The measure(s) used in response to the application of the standard shock will depend, inter alia, on the complexity of the calculation method used and the appropriateness of the standard shock and the level of the economic value.

If the reduction in economic value is determined by a relatively straightforward or standard method of calculation, the initial supervisory reaction might be to request additional, possibly internal, information. If, however, the reduction is based on the outcome of a more complex model about which the supervisors have greater information, they might reach an assessment of the appropriate measure(s) more quickly.

In the latter case, the choice of the measure can take into account elements such as:

- the absolute and relative size of the exposure,
- the effects of other shifts or twists in the yield curve (other than the standardised),
- the treatment of multi-currency aggregation,
- the treatment of optionality and behavioural maturity, for example of current and savings accounts,

- the expected impact on earnings and the timing thereof,
- the quality of risk management, the internal systems and methodologies and the internal control system,
- the market segments in which the institution is active,
- the link with other risk exposures of the institution, for example credit risk,
- peer group comparison (and benchmarking where the methodologies are similar),
- the composition of the institution's own funds, and
- the relationship between the quantity of the institution's internal capital and regulatory own funds and the quantity of its actual surplus of regulatory own funds.

## **Appendix I**

### **Basel Supporting Document on Interest Rate Risk**

The 15 principles given in the Basel Supporting Document - [Principles for the Management and Supervision of Interest Rate Risk, July 2004](#), are listed below.

#### ***Board and senior management oversight of interest rate risk***

*Principle 1:* In order to carry out its responsibilities, the board of directors in a bank should approve strategies and policies with respect to interest rate risk management and ensure that senior management takes the steps necessary to monitor and control these risks consistent with the approved strategies and policies. The board of directors should be informed regularly of the interest rate risk exposure of the bank in order to assess the monitoring and controlling of such risk against the board's guidance on the levels of risk that are acceptable to the bank.

*Principle 2:* Senior management must ensure that the structure of the bank's business and the level of interest rate risk it assumes are effectively managed, that appropriate policies and procedures are established to control and limit these risks, and that resources are available for evaluating and controlling interest rate risk.

*Principle 3:* Banks should clearly define the individuals and/or committees responsible for managing interest rate risk and should ensure that there is adequate separation of duties in key elements of the risk management process to avoid potential conflicts of interest. Banks should have risk measurement, monitoring and control functions with clearly defined duties that are sufficiently independent from position-taking functions of the bank and which report risk exposures directly to senior management and the board of directors. Larger or more complex banks should have a designated independent unit responsible for the design and administration of the bank's interest rate risk measurement, monitoring, and control functions.

#### ***Adequate risk management policies and procedures***

*Principle 4:* It is essential that banks' interest rate risk policies and procedures are clearly defined and consistent with the nature and complexity of their activities. These policies should be applied on a consolidated basis and, as appropriate, at the level of individual affiliates, especially when recognizing legal distinctions and possible obstacles to cash movements among affiliates.

*Principle 5:* It is important that banks identify the risks inherent in new products and activities and ensure these are subject to adequate procedures and controls before being introduced or undertaken. Major hedging or risk management initiatives should be approved in advance by the board or its appropriate delegated committee.

### ***Risk measurement, monitoring, and control functions***

*Principle 6:* It is essential that banks have interest rate risk measurement systems that capture all material sources of interest rate risk and that assess the effect of interest rate changes in ways that are consistent with the scope of their activities. The assumptions underlying the system should be clearly understood by risk managers and bank management.

*Principle 7:* Banks must establish and enforce operating limits and other practices that maintain exposures within levels consistent with their internal policies.

*Principle 8:* Banks should measure their vulnerability to loss under stressful market conditions - including the breakdown of key assumptions - and consider those results when establishing and reviewing their policies and limits for interest rate risk.

*Principle 9:* Banks must have adequate information systems for measuring, monitoring, controlling and reporting interest rate exposures. Reports must be provided on a timely basis to the bank's board of directors, senior management and, where appropriate, individual business line managers.

### ***Internal controls***

*Principle 10:* Banks must have an adequate system of internal controls over their interest rate risk management process. A fundamental component of the internal control system involves regular independent reviews and evaluations of the effectiveness of the system and, where necessary, ensuring that appropriate revisions or enhancements to internal controls are made. The results of such reviews should be available to the relevant supervisory authorities.

### ***Information for supervisory authorities***

*Principle 11:* Supervisory authorities should obtain from banks sufficient and timely information with which to evaluate their level of interest rate risk. This information should take appropriate account of the range of maturities and currencies in each bank's portfolio, including off-balance sheet items, as well as other relevant factors, such as the distinction between trading and non-trading activities.

### ***Capital adequacy***

*Principle 12:* Banks must hold capital commensurate with the level of interest rate risk they undertake.

### ***Disclosure of interest rate risk***

*Principle 13:* Banks should release to the public information on the level of interest rate risk and their policies for its management.

### ***Supervisory treatment of interest rate risk in the banking book***

*Principle 14:* Supervisory authorities must assess whether the internal measurement systems of banks adequately capture the interest rate risk in their banking book. If a bank's internal measurement system does not adequately capture the interest rate risk, banks must bring the system to the required standard. To facilitate supervisors' monitoring of interest rate risk exposures across institutions, banks must provide the results of their internal measurement systems, expressed in terms of the threat to economic value, using a standardized interest rate shock.

*Principle 15:* If supervisors determine that a bank is not holding capital commensurate with the level of interest rate risk in the banking book, they should consider remedial action, requiring the bank either to reduce its risk, to hold a specific additional amount of capital, or a combination of both.

## **Appendix II**

### **Basel Committee on Banking Supervision-**

#### **Principles for the management and supervision of interest rate risk-July 2004**

##### **Annex 4 - An example of a standardized framework**

1. This annex contains an example setting out the methodology and calculation process in one version of a standardized framework. Other methodologies and calculation processes could be equally applicable in this context, depending on the circumstances of the bank concerned. Such a framework is intended for supervisory reporting purposes only, and is not intended to represent an adequate framework for internal risk management purposes.

##### **A. Methodology**

2. Positions on the bank's balance sheet would be slotted into the maturity approach according to the following principles:

(a) All assets and liabilities belonging to the banking book and all OBS items belonging to the banking book which are sensitive to changes in interest rates (including all interest rate derivatives) are slotted into a maturity ladder comprising a number of time bands large enough to capture the nature of interest rate risk in a national banking market. Annex 2 discusses issues relating to the selection of appropriate time bands. Separate maturity ladders are to be used for each currency accounting for more than 5% of either banking book assets or liabilities.

(b) On-balance-sheet items are treated at book value.

(c) Fixed-rate instruments are allocated according to the residual term to maturity and floating-rate instruments according to the residual term to the next repricing date.

(d) Exposures which create practical processing problems because of their large number and relatively small individual amount (e.g. installment or mortgage loans) may be allocated on the basis of statistically supported assessment methods.

(e) Core deposits are slotted according to an assumed maturity of no longer than five years.

(f) National supervisors will provide guidance on how other items with a behavioural maturity or repricing that differ from contractual maturity or repricing are to be slotted into the time band structure.

(g) Derivatives are converted into positions in the relevant underlying. The amounts considered are the principal amount of the underlying or of the notional underlying.

(h) Futures and forward contracts, including forward rate agreements (FRA), are treated as a combination of a long and a short position. The maturity of a future or a FRA will be the period until delivery or exercise of the contract, plus - where applicable - the life of the underlying instrument. For example, a long position in a June three month interest rate future (taken in April) is to be reported as a long position with a maturity of five months and a short position with a maturity of two months.

(i) Swaps are treated as two notional positions with relevant maturities. For example, an interest rate swap under which a bank is receiving floating-rate interest and paying fixed-rate interest will be treated as a long floating-rate position of maturity equivalent to the period until the next interest fixing and a short fixed-rate position of maturity equivalent to the residual life of the swap. The separate legs of cross currency swaps are to be treated in the relevant maturity ladders for the currencies concerned.

(j) Options are considered according to the delta equivalent amount of the underlying or of the notional underlying.

## **B. Calculation process**

3. The calculation process consists of five steps.

(a) The first step is to offset the longs and shorts in each time band, resulting in a single short or long position in each time band.

(b) The second step is to weight these resulting short and long positions by a factor that is designed to reflect the sensitivity of the positions in the different time bands to an assumed change in interest rates. The set of weighting factors for each time band is set out in Table 1 below. These factors are based on an assumed parallel shift of 200 basis points throughout the time spectrum, and on a proxy of modified duration of positions situated at the middle of each time band and yielding 5%.

(c) The third step is to sum these resulting weighted positions, offsetting longs and shorts, leading to the net short- or long-weighted position of the banking book in the given currency.

(d) The fourth step is to calculate the weighted position of the whole banking book by summing the net short- and long-weighted positions calculated for different currencies.

(e) The fifth step is to relate the weighted position of the whole banking book to capital.

**Table 1 is provided in the Basel document itself.**

## 5.2.2. Technical aspects of the management of concentration risk under the supervisory review process <sup>112</sup>

### Executive Summary

- 1 CEBS refers in its guidelines on the Application of the Supervisory Review Process under Pillar 2 to a structured dialogue between supervisors and institutions that should embrace four types of risks (i) Pillar 1 risks, (ii) risks not fully captured under Pillar 1, (iii) risks covered by Pillar 2 and (iv) external factors not already considered in the previous cases<sup>113</sup>.
- 2 In particular, institutions should develop and maintain an ICAAP<sup>114</sup> that identifies risks they are, or might be exposed to and allocate adequate financial resources against those risks.
- 3 This paper addresses concentration risk, one of those risks mainly captured under Pillar 2.
- 4 The document puts the emphasis on high level guidance, some of which is applicable to institutions (both credit institutions and investment firms) and some to supervisors. It is not meant to provide detailed guidance on whether and how quantitative tools and models should be used or developed.
- 5 CEBS survey of market practices<sup>115</sup> carried out in 2006 shows that there is a wide range of practices, from simple methodologies of measuring and managing concentration risk to sophisticated economic models. In economic capital models, concentration risk is not necessarily taken into account as a separate component but is rather modeled implicitly under a wider risk assessment. These guidelines have been developed with this in mind. It is therefore important for supervisors to adopt a flexible and proportionate approach when undertaking their supervisory review, allowing in particular for the complexity of an institution's business and the sophistication of the methodologies it uses.
- 6 It is also recognised that as market practices are still developing, there is a need to ensure that such a technical paper is kept under review and, to the extent necessary, adapted in the light of any future developments and experience.

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<sup>112</sup> As to the history of the technical guidelines on concentration risk, the document on the CEBS website can be found under the following link: <http://www.c-eps.org/documents/Publications/Standards---Guidelines/files-from-old-website/GL03Cr.aspx>

<sup>113</sup> See Chapter 4: the SREP-ICAAP interaction and prudential measures. Dialogue 2.

<sup>114</sup> ICAAP stands for Internal Capital Adequacy Assessment Process

<sup>115</sup> See [http://www.c-eps.org/documents/Publications/Advice/website/LE\\_industryreport.aspx](http://www.c-eps.org/documents/Publications/Advice/website/LE_industryreport.aspx)

- 7 The document sets out general considerations including current international thinking, a definition of what concentration risk might cover the relevant legal requirements of the Capital Requirements Directive<sup>116</sup> and a summary of current market practices. This, together with the supervisory considerations, explains the context that has led to the guidelines.
- 8 The paper then sets out technical guidelines as follow-up to CEBS Guidelines on the Supervisory Review Process, addressing institutions as well as supervisors:
- a) the guidance for institutions sets out what institutions should take into account in relation to concentration risk in their ICAAP, under which it is the institution's own responsibility to adequately manage (i.e. identify, measure, monitor and control) these risks and allocate internal capital, where considered necessary, in support of concentration risk in a structured manner;
  - b) the guidance for supervisors outlines how concentration risk should be addressed in the context of the Supervisory Review and Evaluation Process (SREP) dialogue. Supervisors will require institutions to show that their internal capital, where considered necessary, is commensurate with the level of concentration risk.
- 9 The concept of proportionality, as laid down in the provisions of the Directive 2006/48/EC related to Pillar 2 and underlined in the introductory statements of CEBS Guidelines on the Supervisory Review Process, applies also to concentration risk measurement and management, the complexity of which will be expected to be related to the size of the institutions as well as to the sophistication and diversification of their activities.
- 10 Therefore, both in relation to points 8 (a) and (b) above, and in accordance with CEBS Guidelines on the Supervisory Review Process, the supervisory authorities will adapt their approach to ensure it is proportionate to the nature, scale and complexity of the activities of an institution. Similarly, the depth, frequency and intensity of the supervisory evaluation will be determined by the risks posed to the supervisor's statutory objectives of ensuring the soundness of the banking sector and protecting depositors.
- 11 CEBS guidelines on the management and mitigation of concentration risk should not be considered as a tick-box list of requirements. As noted earlier, supervisors should adopt a flexible approach when undertaking their supervisory review and consider the appropriateness of the following guidelines to the nature and context of the institution's business. Specifically, in accordance with the principle of proportionality, it is important to note that when the

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<sup>116</sup> The Directives 2006/48/EC and 2006/49/EC.

paper refers to internal capital, it is not required that institutions use economic capital models.

- 12 It is noted that the large exposures review by the European Commission<sup>117</sup> is still under way and since large exposure and concentration risk are closely related, it will probably be necessary to review the present guidelines in light of the outcome of that review. In these circumstances it has been questioned whether it would make more sense to defer issuing these guidelines until the Commission has completed its review of large exposures. However, CEBS considers that it is necessary to have these guidelines as part of the CRD implementation process.
- 13 The draft guidelines went through a three-month public consultation as the second part of the 11<sup>th</sup> Consultation paper of CEBS. As mentioned, the finalisation of the guidelines has also benefited from information gathered by CEBS in its survey of industry practices carried out in the context of the large exposures review. This explained the extension of the timeline for publishing final guidelines.
- 14 The guidelines have finally been informed by further dialogue with a panel of experts nominated by the CEBS Consultative Panel.
- 15 Attached to this paper is a feedback which contains a summary of the key points arising from the consultation and the responses made to address them. It includes an annex reflecting CEBS' views on the detailed comments received.

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<sup>117</sup> Article 119 of the Directive 2006/48/EC states that by 31 December 2007, the Commission shall submit to the European Parliament and to the Council a report on the functioning of the large exposures regime in the CRD, together with any appropriate proposals.

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**Appendix I** [Basel Committee on Banking Supervision-International Convergence of Capital measurement and Capital Standards](#), Paragraph 770-777 – June 2004.

### General considerations

- 1 Concentration risk is regarded as one of the most important potential causes of major institutions losses, which may become large enough to jeopardise an institution's on-going operations.
- 2 Concentration risk is viewed in terms of both traditional on balance sheet exposures and those embodied in a range of financial instruments and off-balance sheet exposures (e.g. credit default swaps). Concentration risk is understood as being intimately related to credit risk, which is analysed and measured as part of the broader credit risk management process, but can also arise in any risk type. As such, concentration risk may arise in both the banking and trading books, with the latter arising in terms of counterparty risk and significant exposure to particular instrument types or instruments whose value is driven by the same common factors.
- 3 Although it is important for all institutions to monitor and control concentration risk both across portfolios and on a consolidated basis, its relative importance will vary. For example, it is likely that it will be relatively less important from a capital adequacy perspective for large internationally active institutions with well diversified portfolios, as Pillar 1 has already been calibrated on the basis of such institutions. On the other hand, it will be relatively more important for institutions with less diversified portfolios - either because they are geographically concentrated or are specialised lenders in particular sectors - to consider the extent to which their business is concentrated and the consequent role of capital in relation to comparative advantages such as expertise and local knowledge. In this respect, it is important to recognise that specialised institutions should not necessarily be assumed to be more risky in comparison with larger institutions doing the same business.

- 4 The concept of proportionality, as laid down in the provisions of the Directive 2006/48/EC related to Pillar 2 and underlined in the introductory statements of CEBS Guidelines on the Supervisory Review Process, applies also to Concentration risk measurement and management, the complexity of which will be expected to be related to the size of the institutions as well as to the sophistication and diversification of their activities.
- 5 Therefore, both in relation to points 8 (a) and (b) above, and in accordance with CEBS Guidelines on the Supervisory Review Process, the supervisory authorities will adapt their approach to ensure it is proportionate to the nature, scale and complexity of the activities of an institution. Similarly, the depth, frequency and intensity of the supervisory evaluation will be determined by the risks posed to the supervisor's statutory objectives of ensuring the soundness of the banking sector and protecting depositors.
- 6 CEBS guidelines on the management and mitigation of concentration risk should not be considered as a tick-box list of requirements. As noted earlier, supervisors should adopt a flexible approach when undertaking their supervisory review and consider the appropriateness of the following guidelines to the nature and context of the institution's business. Specifically, in accordance with the principle of proportionality, it is important to note that when the paper refers to internal capital, it is not required that institutions use economic capital models.
- 7 The obverse to concentration is diversification, so it is important to understand the potential of correlation analysis to measure both concentration and diversification. An insufficiently granular analysis or an analysis that does not explore, to a sufficient degree the common factors affecting exposures and their correlation, will not adequately capture or measure concentration risk.

## **International context**

- 8 Concentration risk is set out in Articles 770-777 of the Basel text of June 2004 (See Appendix I below). It has been ensured that the guidelines below are consistent with current international thinking as set out in the Basel text.

## **Definition**

- 9 For the purpose of this paper, concentration risk is any single (direct and/or indirect) exposure or group of exposures with the potential to produce losses large enough to threaten an institutions health or its ability to maintain its core business.

10 Concentration risk arises from:

- large (possibly connected<sup>118</sup>) individual exposures - the definition of connected for these purposes needs to be sufficiently broad to capture exposures which are connected through, for example, common ownership/management/guarantors. This kind of concentration may be broadly covered, in particular in institutions which use quantitative modeling techniques, via granularity adjustments in the context of Pillar 2 measures, and
- significant exposures to groups of counterparts whose likelihood of default is driven by common underlying factors, for example:
  - economic sector,
  - geographical location,
  - currency,
  - credit risk mitigation measures (including, for example, risks associated with large indirect credit exposures to a single collateral issuer).

## Legal Basis

11 Under Directive 2006/48/EC, concentration risk is addressed in particular as follows:

*Annex V - Technical criteria on organisation and treatment of risks.*

Paragraph 7 The concentration risk arising from exposures to counterparties, groups of connected counterparties, and counterparties in the same economic sector, geographic region or from the same activity or commodity, the application of credit risk mitigation techniques, including in particular risks associated with large indirect credit exposures (e.g. to a single collateral issuer) shall be addressed and controlled by means of written policies and procedures.

*Annex XI- Technical criteria on review and evaluation by the competent authorities.*

1. In addition to credit, market and operational risks, the review and evaluation performed by competent authorities pursuant to Article 124 shall include the following: (a)...

b) the exposure to and management of concentration risk by the credit institutions, including their compliance with the requirements laid down in Articles 108 to 118.

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<sup>118</sup> As defined by Article 4(45) of Directive 2006/48/EC.

- 12 Such requirements fall under the more general provisions of Article 123 for institutions to have sound, effective and complete strategies and processes to assess and maintain on an ongoing basis the amounts, types and distribution of internal capital that they consider adequate to cover the nature and level of the risks to which they are, or might be exposed; and for these strategies and processes to be subject to regular internal review to ensure that they remain comprehensive and proportionate to the nature, scale and complexity of the activities of the credit institution concerned.
- 13 In addition to the specific provisions on concentration risk included in the Directive 2006/48/EC, institutions will continue to be subject to the rules on monitoring and control of large exposures provided for in Articles 106 to 118.

#### Current Market Practices

- 14 As indicated in the CEBS survey of industry practices<sup>119</sup>, there are numerous ways that financial institutions currently identify and measure concentration risk.
- 15 The complexity and the degree of the sophistication of the methodologies reflect both the specific form of the risk in question, and the nature, scale and complexity of institution involved, and are typically a product of the approach being taken to credit risk measurement and management by the individual institution.
- 16 With regard to the single-name concentration risk, almost all respondents to the CEBS survey indicated that they used an approach based on notional/nominal exposure limits. A significant number of respondents – mostly, but not exclusively, larger or more sophisticated institutions – indicated that they also use approaches based on economic capital models.
- 17 In economic capital models, concentration risk is not necessarily taken into account as a separate component but is rather modeled implicitly under a wider risk assessment.
- 18 With respect to the connectedness of counterparties, institutions work on the basis of common/legal direct or indirect ownership, management control or financial dependencies. It is determined, for many institutions, case-by-case with the aid of both quantitative tools and qualitative judgements.
- 19 Some institutions consider two kinds of concentrations risk: single name and what is called ‘other concentration risk’, namely the risk arising from a group of exposures that share the same underlying risk factors (exposures in the same sector or the same geographical region) such that a deterioration in the common risk factors could affect the ability of all the counterparties to service their debt.

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<sup>119</sup> [http://www.c-eps.org/documents/Publications/Advice/website/LE\\_industryreport.aspx](http://www.c-eps.org/documents/Publications/Advice/website/LE_industryreport.aspx)

- 20 Based on that classification institutions perform specific approaches and have different tools. Stress testing techniques are also conducted by a number of institutions – mostly large and medium-sized institutions.
- 21 Defining the relevant sectors and geographical areas was identified by respondents as one of the first steps in managing concentration risk. From a review of the responses to the CEBS survey, institutions seem to identify the country risk mainly with objective/factual indicators, however, delineating a 'sector' seems to prove more judgmental.
- 22 Most of the institutions which participated in the CEBS survey of market practices with regard to the measurement and management of large exposures and other concentration risk, indicated that measurement of concentration risk is a part of an institution's overall approach to credit risk management, and the approach adopted will usually reflect the nature, scale and complexity of the institution in question. A mixture of tools and approaches are used to address 'other concentration risk,' including limits, distribution charts by sectors, reporting and judgemental considerations around high-risk areas. Some of the more sophisticated institutions reported they use methodologies based on economic capital or VaR models.
- 23 The more sophisticated institutions reported conducting stress tests using economic capital models. When using stress tests, less sophisticated institutions reported they take different scenarios into account in their analysis, but using simpler methods. Respondents noted that stress tests are a tool adopted to help identify and manage a broad spectrum of risks (including concentration risk), but they are not targeted specifically at concentration risks.

**(i) Identification and measurement of concentration risk**

24 A range of methods are used for the measurement of concentration risk including:

- (a) Single/connected counterparties/exposure types** are readily measured in terms of simple metrics that reflect the size discrepancies embodied in concentration risk. Individual counterparty metrics, such as notional exposure or a combination of notional exposure and LGD relative to a balance sheet total can be calculated. In addition, a range of portfolio indicators e.g. rankings of the largest exposures, diversity scores<sup>120</sup> or concentration curves<sup>121</sup> can also be calculated.

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<sup>120</sup> Diversity Scores are analogous to the Herfindahl-Hirschmann index (HHI) used in market structure analysis. The HHI is calculated from the sum of the squares of the percentages of the shares of the exposures. The value of the HHI must lie between 0 and 10,000, with larger values indicating higher concentration. It

**(b) Common or correlated underlying factors.** A more sophisticated portfolio based approach is sometimes adopted where common risk factors have been analysed, whereby correlations in probability of default can be identified. Taking a portfolio view, concentration reflects an interaction between individual exposures and correlation. The data available when more sophisticated credit risk modeling is undertaken should allow the assessment of correlations and the calculation of diversification effects.

25 Examples of tools include the following:

- Size of top 'x' large exposures relative to relevant numeraire (e.g. balance sheet/own funds/net profit numeraire);
- Size of top 'x' connected exposures relative to relevant numeraire;
- Size of key sectoral/geographical concentrations relative to relevant numeraire;
- As examples of contributory factors in economic capital models: Portfolio concentration ratios, Diversity scores, Concentration curves, Gini coefficients<sup>122</sup>; Portfolio correlations and variance / covariance measures.

## **(ii) Mitigation of concentration risk**

26 Many respondents to the CEBS survey reported that they use credit risk mitigation to reduce their concentration risk, using a range of tools, both quantitative (e.g. limit structures) and qualitative (e.g. management actions such as reporting and escalation procedures), that are used for balance sheet management more broadly.

27 Some institutions capture and monitor correlated exposures, both on and off balance sheet, and set risk based limits accordingly. Limits might be risk sensitive regarding the counterparty's creditworthiness or the perceived risk of a certain sector or region, and may take into account other factors such as the nature of the product, maturity/tenor, the purpose of credit and sources of payment.

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measures the extent to which a small number of sectors/countries/counterparties account for a large proportion of exposure. HHI is related to exposure concentration or, if appropriately modified, to expected losses.

<sup>121</sup> A concentration curve provides a means of assessing for instance whether a certain risk is more concentrated in some countries/sectors than in others.

<sup>122</sup> Gini coefficient can be used to measure any form of uneven distribution. It is a number between 0 and 1, where 0 corresponds with complete risk homogeneity (where every exposure has the same risk) and 1 corresponds with absolute concentration (where one exposure carries all the risks, and the other exposures have zero risks).

- 28 The sophistication of the methods used by institutions appears to vary depending on the size of the institution. Some respondents to the CEBS survey flagged that there is a gap between the range of credit risk mitigation techniques developed by part of the industry and the credit risk mitigation techniques eligible for regulatory purposes laid down in the Capital Requirements Directive.
- 29 There is a range of mitigants for concentration risk used by institutions, including, but not limited to, combinations of:
- **Limits:** comprehensive credit limit systems, which identify large individual exposures/connected counterparties; and reflect ongoing portfolio monitoring and risk appetite in terms of concentration risk. The Large Exposures requirements of the CRD may be a useful starting point but may not, in themselves, be sufficient for institutions in defining their own internal limits. Most institutions set sector, country and product line limits. Some capture and monitor correlated exposures, both on and off balance sheet, and set limits accordingly.
  - **Portfolio management:** monitoring of risk concentrations through active portfolio management enables institutions to adjust their new business acquisition to correct for undue concentrations which have arisen, or may arise.
  - **Risk transfer:** using a systematic approach to transferring credit risk to another party, either directly by selling down the assets or as part of structured securitisation transactions or by buying protection from other parties (examples include credit derivatives, collateral, guarantees, sub-participation, assignment).
  - **Capital buffers:** it is common for some institutions to hold additional capital buffers above their required minimum regulatory capital, making an additional general, rather than specific capital allocation for concentration risk in the portfolio.

### (iii) Stress testing

- 30 As indicated in paragraphs 35 and 38 above, some institutions reported using stress testing as a tool for the assessment and management of concentration risk.
- 31 During periods of economic calm, concentrations in an institution's portfolio are unlikely to have any noticeable adverse effects on performance or credit quality as usually measured and, as such, can remain latent. However, the real threat arises in an adverse economic scenario, where connected or correlated exposures all show increased risk of default or actually default at the same time. Stress testing may reveal previously undetected linkages between different elements of an institution's portfolio. In this context, well

designed, comprehensive and regular stress tests of institutions' portfolios may serve as a useful tool in managing concentration risk.

## GUIDANCE FOR INSTITUTIONS

### *Concentration 1*

**All institutions should have clear policies and key procedures ultimately approved by the management body<sup>123</sup> in relation to exposure to concentration risk**

- 47 Institutions should have a clear and transparent concentration risk policy, as part of the broader credit risk process, which is clearly and properly documented and approved by the management body. It should be subject to regular review to take account of changes in risk appetite and the business environment.
- 48 When devising their policies and procedures and when carrying out their review, institutions should bear in mind the CEBS guidelines on internal governance<sup>124</sup>.

### *Concentration 2*

**In application of Article 22 of the Capital Requirements Directive, institutions should have appropriate internal processes to identify, manage, monitor and report concentration risk, which are suitable to the nature, scale and complexity of their business.**

- 49 Institutions should have internal processes that identify, measure and monitor concentration risk encompassing, for example:
- individual large exposures to a single counterparty, connected counterparties and related clusters - the definition of connected for these purposes needs to be sufficiently broad to capture exposures which are connected through, for example, common ownership / management / guarantors / syndication techniques,
  - exposures to counterparties in the same economic sector or geographic region, or
  - CRM techniques, collateral type or single protection seller.

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<sup>123</sup> As referred to in Article 11 of the Directive 2006/48/EC - [http://eur-lex.europa.eu/LexUriServ/site/en/oj/2006/l\\_177/l\\_17720060630en00010200.pdf](http://eur-lex.europa.eu/LexUriServ/site/en/oj/2006/l_177/l_17720060630en00010200.pdf)

<sup>124</sup> See CEBS guidelines on the Application of the supervisory review process under Pillar 2, Chapter 2.1

- 50 For more complex businesses and for sophisticated institutions, this might also encompass common or correlated risk factors that reflect more subtle or situation-specific factors that require more sophisticated analysis for measurement and control. These concentrations may reflect correlations in underlying risk factors or exposure to common factors that are embedded in financial structures and may only become apparent in stress situations (see below).

### ***Concentration 3***

#### **Institutions should use internal limits, thresholds or similar concepts, as appropriate, having regard to their overall risk management and measurement.**

- 51 Institutions should establish, as appropriate, a set of limits thresholds or similar concepts for credit risk management. Procedures should be in place for the utilisation of such limits thresholds or similar concepts ensuring that the degree of credit risk stipulated by the management body is not exceeded.
- 52 Institutions should carry out analyses of the credit portfolio, including estimates of its trends, and should take account of the results of these analyses in setting and verifying the adequacy of the procedures and limits, thresholds or similar concepts for credit risk management.
- 53 The following sets out some examples for the expression of limits thresholds or similar concepts:
- Size of top 'x' large exposures relative to relevant numeraire (e.g. balance sheet/own funds/net profit numeraire);
  - Size of top 'x' connected exposures relative to relevant numeraire;
  - Size of key sectoral/geographical concentrations relative to relevant numeraire;
  - As contributory factors in economic capital model: Portfolio concentration ratios, Diversity scores, Concentration curves, Gini coefficients<sup>125</sup>; Portfolio correlations and variance/ covariance measures.

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<sup>125</sup> Gini coefficient can be used to measure any form of uneven distribution. It is a number between 0 and 1, where 0 corresponds with complete risk homogeneity (where every exposure has the same risk) and 1 corresponds with absolute concentration (where one exposure carries all the risks, and the other exposures have zero risks).

#### **Concentration 4**

**Institutions should have adequate arrangements in place for actively monitoring, managing and mitigating concentration risk against agreed policies and limits, thresholds or similar concepts.**

- 54 Monitoring should be incorporated into the institution's usual risk management and reporting systems and be undertaken sufficiently frequently to reflect the nature of the business(es) and at a sufficiently senior level within the institution.
- 55 Given that concentration risk, by its nature, tends to relate to aggregation of risk it is essential that appropriate oversight is exercised by the management body ultimately at a strategic level.
- 56 If issues of concern are identified by the monitoring activity, an institution's management should consider those issues and the appropriate response. Management responses might, for example, include but are not limited to:
  - proceeding to a more detailed review of the risk environment in the particular sector(s),
  - applying additional stress tests and scenario analyses,
  - reviewing with greater intensity the economic performance of existing borrowers,
  - reviewing approval levels for new business, or
  - regularly reviewing risk mitigation techniques, their value and their legal enforceability.
- 57 Having assessed an issue, an institutions management may conclude that it is appropriate to take mitigating action. For example, one or more of the following might be considered appropriate:
  - reducing limits or thresholds on risk concentrations,
  - adjusting new business acquisition to address undue concentrations,
  - transferring credit risk to other parties, buying protection from other parties (examples include credit derivatives, collateral, guarantees, sub-participation, assignment) or selling down either directly or as part of securitization transactions, or
  - allocating additional internal capital (see Concentration 5 below).

### ***Concentration 5***

**Institutions should assess the amount of internal capital which they consider to be adequate to hold against the level of concentration risk in their portfolio.**

- 58 Institutions should undertake this assessment as part of their ICAAP, in a transparent way. In doing so, they should take account of a range of relevant factors, including the quality of their risk management and other internal systems and controls, ability to take effective management action to adjust levels of concentration risk and the implications of stress-testing and scenario analysis.
- 59 While the role of capital therefore needs to be assessed within this broader context, and keeping in mind that the weight attached to the different factors will vary from institution to institution, the expectation is that the higher the levels of concentration, the greater the onus will be on institutions to demonstrate how they have assessed the implications in terms of internal capital.

## GUIDANCE TO SUPERVISORS

### *Concentration 6*

**Supervisors will collect sufficient information from institutions on which to base their assessment.**

- 60 This information should come from a variety of sources, both on-site and off-site.
- 61 Off-site supervision (i.e. desk analysis) allows supervisors to draw on a combination of institutions' own internal reports, standardised supervisory and statistical returns (e.g. as used for reporting individual large exposures and sectoral analysis) and specifically designed questionnaires for thematic purposes.
- 62 On-site supervision enables supervisors to (i) make first-hand assessments of the quality of an institution's policies and procedures and how effectively the institution manages and controls concentration risk, including management of risk mitigation techniques, and to (ii) verify as necessary the accuracy of reported data. Supervisors will usually have quantitative and qualitative methods for conducting such on-site assessments.
- 63 This information will assist supervisors to assess individual institutions in relation to their peers.

### *Concentration 7*

**The scope of application of the supervisors' assessment of concentration risk is that used for the Supervisory Review Process (SRP)<sup>126</sup>.**

- 64 Where necessary, supervisors will also have the discretion to apply an assessment at the level of individual entities.

### *Concentration 8*

**Supervisors will use quantitative indicators, where appropriate, within their Risk Assessment Systems to assess degrees of concentration risk.**

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<sup>126</sup> The Scope of application of the SRP is set out in the introduction to the CEBS guidelines on the Application of the Supervisory review Process under Pillar 2.

- 65 Supervisors can build up these indicators based on the set of limits, thresholds or similar concepts defined internally by institutions (see Concentration 3). They may also develop their own models and tools such as indicators based on the existing regular reporting from institutions, including the reporting of large exposures or geographical / sectoral risks against regulatory capital.
- 66 These indicators may be used within the supervisor's risk assessment systems to carry out peer comparisons and identify outliers.

### ***Concentration 9***

**The supervisory review should encompass not only quantitative aspects but also the qualitative and organisational aspects of concentration risk management.**

- 67 Supervisors recognise that the assessment and management of concentration risk does not only rely on quantitative modelling techniques but also on qualitative factors e.g. the expertise of people with regard to the identification and management of risks in individual sectors or sub-sectors .

### ***Concentration 10***

**Supervisors can draw on stress tests performed by institutions to assess the impact of specific economic scenarios on concentrated portfolios.**

- 68 Supervisors will use the results of stress testing to assess the full extent to which adverse economic conditions impact on highly connected or correlated exposures.

### ***Concentration 11***

**Supervisors will pay particular attention to those institutions which are highly concentrated by customer type or specialized nature of product.**

- 69 In doing so, supervisors note that such institutions should not necessarily be assumed to be more risky in comparison with larger and / or more complex institutions doing the same business given the possible existence of comparative advantages such as expertise and local knowledge. At the same time, however, it will be relatively more important in such circumstances for supervisors to consider whether such institutions have adequately assessed the role of capital in conjunction with other relevant factors such as expertise and local knowledge.

## Appendix I

### Basel Committee on Banking Supervision

#### International Convergence of Capital measurement and Capital Standards – June 2004

##### *Credit concentration risk*

70. A risk concentration is any single exposure or group of exposures with the potential to produce losses large enough (relative to a bank's capital, total assets, or overall risk level) to threaten a bank's health or ability to maintain its core operations. Risk concentrations are arguably the single most important cause of major problems in banks.
71. Risk concentrations can arise in a bank's assets, liabilities, or off-balance sheet items, through the execution or processing of transactions (either product or service), or through a combination of exposures across these broad categories. Because lending is the primary activity of most banks, credit risk concentrations are often the most material risk concentrations within a bank.
72. Credit risk concentrations, by their nature, are based on common or correlated risk factors, which, in times of stress, have an adverse effect on the creditworthiness of each of the individual counterparties making up the concentration. Such concentrations are not addressed in the Pillar 1 capital charge for credit risk.
73. Banks should have in place effective internal policies, systems and controls to identify, measure, monitor, and control their credit risk concentrations. Banks should explicitly consider the extent of their credit risk concentrations in their assessment of capital adequacy under Pillar 2. These policies should cover the different forms of credit risk concentrations to which a bank may be exposed. Such concentrations include:
- Significant exposures to an individual counterparty or group of related counterparties. In many jurisdictions, supervisors define a limit for exposures of this nature, commonly referred to as a large exposure limit. Banks might also establish an aggregate limit for the management and control of all of its large exposures as a group;
  - Credit exposures to counterparties in the same economic sector or geographic region;

- Credit exposures to counterparties whose financial performance is dependent on the same activity or commodity; and
  - Indirect credit exposures arising from a bank's CRM activities (e.g. exposure to a single collateral type or to credit protection provided by a single counterparty).
74. A bank's framework for managing credit risk concentrations should be clearly documented and should include a definition of the credit risk concentrations relevant to the bank and how these concentrations and their corresponding limits are calculated. Limits should be defined in relation to a bank's capital, total assets or, where adequate measures exist, its overall risk level.
75. A bank's management should conduct periodic stress tests of its major credit risk concentrations and review the results of those tests to identify and respond to potential changes in market conditions that could adversely impact the bank's performance.
76. A bank should ensure that, in respect of credit risk concentrations, it complies with the Committee document [\*Principles for the Management of Credit Risk \(September 2000\)\*](#) and the more detailed guidance in the Appendix to that paper.
77. In the course of their activities, supervisors should assess the extent of a bank's credit risk concentrations, how they are managed, and the extent to which the bank considers them in its internal assessment of capital adequacy under Pillar 2. Such assessments should include reviews of the results of a bank's stress tests. Supervisors should take appropriate actions where the risks arising from a bank's credit risk concentrations are not adequately addressed by the bank.

### 5.2.3 Technical Guidelines on Stress Testing under the Supervisory Review Process

Technical aspects of stress testing under the supervisory review process<sup>127</sup>

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<sup>127</sup> As to the history of the technical guidelines on stress testing under the supervisory review process the document is on the website under the following link: <http://www.c-eps.org/documents/Publications/Standards---Guidelines/files-from-old-website/GL03stresstesting.aspx>

## I. Executive summary

1. This paper contains guidelines that reflect a common understanding among European supervisory authorities on the stress testing processes to be used by institutions under the Capital Requirements Directive (CRD)<sup>128</sup> with respect to Pillar 2 provisions. As reviewing Pillar 1 risks is part of the supervisory review process, this paper reflects also interactions with relevant provisions regarding Pillar 1.
2. The guidelines elaborate on CRD requirements with respect to stress testing in terms of risk management and for the assessment of capital adequacy. They aim to provide some clarification in relation to stress testing as part of the CEBS Guidelines on the Application of the Supervisory Review Process (SRP). Accordingly, they will be implemented as part of the SREP/ICAAP dialogue and should not be interpreted as resulting in automatic capital add-ons (see ST 14).
3. The concept of proportionality, laid down in CRD provisions related to Pillar 2 and underlined in the introductory statements of CEBS's guidelines on the application of the supervisory review process, applies also to stress testing, the complexity of which will be expected to be related to the size of the institutions as well as to the sophistication and diversification of their activities.
4. The guidelines describe objectives and desired outcomes. CEBS recognises that Stress testing is primarily an internal instrument of the institutions. Earnings are a part of an institution's overall capital planning and are the first line of defence to absorb losses. Therefore, institutions should consider, in the context of their internal capital adequacy assessment process –ICAAP- assessing how their earnings are affected by stress situations.
5. CEBS also acknowledges that institutions currently are on different points of a continuum. There is no single 'correct' stress testing methodology or procedure. What is adequate for an individual institution depends very much on proportionality and the development of its practices over time. An important part of the supervisors' assessment of stress testing will therefore be based on an on-going dialogue with institutions.
6. Since evolving industry practices and the practical application of these guidelines will enlarge supervisors' experience, they will be subject to maintenance following implementation of the CRD, when and where necessary.
7. These guidelines are drafted as guidance to supervisors, elaborating further on the guidance given by CEBS in other Guidelines. However, since the guidelines express CEBS's expectations of how national

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<sup>128</sup> Except where noted otherwise, all references to Articles of the CRD are references to Directive 2006/48/EC.

supervisory authorities should deal with the stress testing of institutions, they clearly also affect the institutions that use these approaches.

8. In interpreting the guidelines, institutions have to distinguish between several types of cases. In cases where the guidelines reflect a common understanding among national supervisors on what they should expect from their institutions, the text discusses what institutions "should" do. In cases where the terms "could," "may" etc. are used the guidelines simply provide illustrative examples, meaning that institutions are free to use other solutions. . The term "should consider" gives institutions the possibility of not applying a suggested action if they think it is not adequate for their purposes without the necessity to explain in detail why they haven't done so. In cases where the CRD is quoted, the text of these guidelines uses "shall."
9. 'Stress testing' as used in these guidelines is a generic term for describing the various techniques (quantitative and/or qualitative) used by institutions to gauge their vulnerability to exceptional but plausible events. Supervisors consider it important for institutions to embed stress testing into their risk management framework. In that respect, the revised Capital Requirements Directive (CRD) contains requirements with regard to stress testing in terms of risk management and for the assessment of capital adequacy.
10. CEBS Guidelines on the Application of the Supervisory Review Process (SRP) also refer to stress testing at several points: in particular, within ICAAP, it is expected that some form of stress testing will be part of internal capital planning. In this context, this paper aims to provide some clarification and guidance on stress testing as part of the CEBS's work related to the SRP. Its objective is threefold:
  - to present the full range of stress tests under the CRD – see Annex 2 - determining the elements of stress testing under the SRP and mapping, where necessary, the inter-relationship between stress testing under Pillar 1 and Pillar 2 (notwithstanding the principle of proportionality, some areas address all institutions, whereas others refer only, e.g., to institutions using IRB approaches under Pillar 1),
  - where appropriate to provide additional guidance on the performance of sound stress testing by institutions in each of the above areas. In doing so, existing industry practices have been taken into account. While most large, complex institutions already have stress testing arrangements in place, on the whole, the use of a broad range of stress tests as a complement to existing risk management tools is currently not widespread. In general terms, the stress testing of market risk is at a somewhat more advanced stage than those for other kinds of risk (e.g. credit or liquidity risk). In contrast, some small institutions have no stress testing arrangements at all. Given this and the new CRD requirements,

the development of guidance, in particular for credit and liquidity risk and for group-wide tests is both necessary and desirable.

- to specify criteria/methodologies for European supervisors to use to review the suitability of stress testing performed by their institutions under the Pillar 2 process.

11. The remainder of the paper is set out in three sections:

- Section II explains what is meant by stress testing and outlines the range of its different uses under Pillar 2,
- Section III provides some general guidelines for both institutions and supervisors on the methodology of sound stress testing, and
- Section IV provides an overview of stress testing by risk categories; it maps, where necessary, the inter-relationship between stress testing under Pillar 1 and Pillar 2; and elaborates, where necessary, additional guidelines for implementation.

12. These guidelines went through a four-month public consultation period and were also discussed in several meetings with industry experts before being endorsed by CEBS. The comments received from the industry have been published on the CEBS website. CEBS feedback on the industry responses received has been published in a separate document (see [www.c-ebs.org](http://www.c-ebs.org) )

## II. Definition and uses of stress testing

### II.1. Definition

13. As defined by the BIS<sup>129</sup>, stress testing is a risk management technique used to evaluate the potential effects on an institution's financial condition of a specific event and/or movement in a set of financial variables. The traditional focus of stress testing relates to exceptional but plausible events.
14. The level of complexity of stress testing is expected to vary with the size and level of sophistication of institutions. This principle of proportionality is further detailed in section III.1

### II.2 Types of stress testing

15. There are a number of other categorisations and concepts currently used by the market or the supervisors. In the context of the ICAAP, stress testing could generally fall within the two following categories and concepts described in paragraph 16: scenario tests and sensitivity analyses. Although for the purposes of this paper the categorisation and concepts introduced in paragraph 16 seemed to be the most helpful<sup>130</sup>, they are only indicative and do not restrict institutions from using their own categorisations and concepts, as long as these approaches meet supervisory expectations.
16. Sensitivity analyses are generally less complex to carry out since they assess the impact on an institution's financial condition of a move in one particular risk driver, the source of the shock not being identified, whereas scenario tests tend to consider the impact of simultaneous moves in a number of risk drivers, the stress event being well-defined. For instance, a typical sensitivity analysis would be to assess the impact on an institution's profitability should interest rates fall sharply in one day. In contrast, a scenario test would consider the impact of, for instance, a 'Black Monday'-like event on an institution's profit and loss account. Such a scenario takes into account a combination of changes in different risk drivers being affected by the stress event chosen by the institution.

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129 Committee of the global financial system, January 2005: Stress testing by large financial institutions: survey results and practice - <http://www.bis.org/publ/cgfs24.htm>

130 For example, the term "scenario tests" and the way this is defined, avoids confusion with the term "scenario analysis" which has a different meaning in the context of Operational risk

### **II.3 Uses of stress testing**

17. In practice, stress testing is a valuable risk management technique whose potential applications are quite varied within each individual institution. In the context of internal capital assessment under Pillar 2 institutions should consider stress testing for the following purposes:

- As a diagnostic tool to improve the institution's understanding of its risk profile.
- As a forward looking tool within the ICAAP.
- Earnings are a part of an institution's overall capital planning and are the first line of defence to absorb losses. Therefore, institutions should consider, in the context of their ICAAP, assessing how their earnings are affected by stress situations.
- Stress testing may be used to assess the adequacy of internal capital. For example, this can be relevant for smaller institutions that may want to tackle their ICAAP through a series of very simple relevant stress tests to inform their view of the adequacy of their internal capital,
- For institutions using internal capital models, stress testing could be used to supplement statistical methodologies (such as VaR). Stress testing helps form an alternative view where paucity of historical data limits the predictive power of such models.
- In line with one of the CEBS Principles listed in the CEBS Guidelines on the Supervisory Review Process (ICAAP 8) institutions should use stress testing as one tool to assess the risks in a forward looking manner. It will then be possible for institutions to compare the outcome of those stress tests against their business plan and take the necessary measures in the light of these results

### **III. Main guidelines underpinning sound stress testing by institutions**

18. This section sets out guidelines applicable to any stress testing, irrespective to its use in the context of internal capital setting and assessment, as well as to the risk drivers inherent in the process. These main guidelines are meant to ensure that stress testing is actually an integral element of the institution's risk management framework. The guidelines for Pillar 2 stress testing set out in section III of this paper in principle also hold true for credit and market risk stress testing but do not override any specific provisions of the CRD.
19. Notwithstanding principle ST9, supervisors should in general not prescribe specific scenarios or specific methodologies for the choice or application of scenarios.

### III.1. Relevance depending on the size and sophistication of institutions

***ST1. The Guidelines on stress testing will be applied to all institutions taking into account their size, sophistication and diversification.***

20. As a general rule, sophisticated institutions should use a combination of both scenario tests and sensitivity analysis (or any other appropriate concept) whereas less complex institutions may develop a less technically demanding approach. In that respect:
- Scenarios with greater coverage across product lines or geographical regions, and considering secondary effects, may be rather employed by large and complex institutions.
  - Less complex institutions may rather confine themselves, considering their risk profile, to simple sensitivity tests run relatively quickly and used by the management body to form a view of the impact of a given variable, or a set of a small number of variables, on the financial condition of the institution under exceptional but plausible adverse movements. This simple measure may already be sufficient for the purpose of ICAAP.
  - Stress testing would in particular be required from institutions with a trading book risk profile irrespective of their size. Stress testing should be calibrated considering the greater complexity of their business activities (e.g. option trading and other non-linear products), taking account, for instance, of volatility.

### III.2. Stress testing coverage

***ST2. In line with one of the principles listed in the CEBS Guidelines on the Supervisory Review Process (ICAAP 7) institutions should identify their material risks. In general, institutions should conduct adequate and proportionate stress tests on all the risks they have identified as material.***

21. Notwithstanding legislative requirements, any stress testing process should start with the institution's own assessment of possible specific vulnerabilities. The main areas which institutions have considerable exposure to (e.g. where they are an active market maker) should be the ones most thoroughly captured under a stress testing framework (see paragraph 85). Institutions should thus determine all material risks that can be subject to stress testing.
22. In line with ICAAP 7, the identification of material risks could stem from:

- A comprehensive review by institutions of the nature and composition of their portfolios. The separation of risk management functions, such as between trading, credit and treasury functions, should not prevent institutions from identifying material factors across business lines that should be incorporated into the stress testing framework for the group.
- A review of the external environment in which institutions are operating with a view to assessing the extent that this could affect their financial condition. To this end, institutions may consider data specific to industries or sectors, macro-economic variables which could affect for instance obligors' ratings, or data related to a specific country or region.

### **III.3. Stress testing calibration**

***ST3. Based upon the identification of material risks, institutions should derive material risk drivers that should be subject to stress testing.***

23. The identification of appropriate risk drivers is crucial to ensure the adequacy of the whole stress testing process. For reporting purposes, in particular, it is essential that any stress test is characterized by a clearly identifiable set of stressed risk drivers, so as to provide useful information giving rise, if necessary, to concrete and adequate action.
24. Institutions should first identify their points of vulnerability in order to stress the relevant risk drivers that may affect their earnings/profitability, solvency or compliance with regulatory requirements. For instance, should interest rate risk be identified as a material risk, institutions should first determine their portfolio vulnerability to a shock in interest rate risk. An analysis of the institution's risks would help it to determine the changes in risk drivers and scenarios the institution would be most affected by.
25. With this in mind, an analysis of past losses can provide valuable information. The institution could identify the cause of past losses and the circumstances under which those are likely to recur. When doing so, the institution should take account of the current composition of its loan and asset portfolios, including pre-emptive management action undertaken to reduce the severity of specific shocks. It should also consider the strategy and business developments it intends to carry out in the near future.
26. Institutions should be able to justify their choice of the risk drivers stressed.

***ST4. Depending on their situation, institutions should consider historical and/or hypothetical scenarios***

27. Historical scenarios may not necessarily reflect an “exceptional but plausible event” and such scenarios may not sufficiently stress the portfolio sensitivities of the institution. Historical events may also fail to capture changes in the nature of the financial markets and new products recently developed. However, historical scenarios (where a range of risk drivers are moved simultaneously) may provide useful information on the way risk drivers behave collectively in a crisis and they may therefore be useful to assess the assumptions of an internal capital model, and in particular correlation estimates.

***ST5. Stress testing should be based on exceptional but plausible events:***

28. When considering the choice of stresses to be performed:

- Stresses and scenarios used should be consistent with the risk appetite that the institution has set to itself. This will usually be an iterative process. The calibration of those stresses should be based upon the institution's ICAAP.
- Institutions should run stress tests of different degrees of severity and likelihood. In doing so, it may be useful to consider recessions of varying degrees of severity that may occur within an economic cycle (e.g. a mild recession and a severe recession).
- When considering historical scenarios, institutions should base stresses on exceptional but plausible scenarios over a given period of time, ideally using data spanning a whole economic cycle.
- Institutions need to understand how severely future profitability (or lack of) can affect their capital. Considering the range of available actions, it is possible that an institution may decide to keep a capital buffer that is not aligned with the exceptional but plausible scenarios performed. However, if this is the case, the institution should be prepared to explain to the supervisory authority how it would cope with an equivalent stress, for instance, by either raising additional capital or by taking management actions.

***ST6. Stress testing should in principle be applied at the same level as the ICAAP***

29. The way the ICAAP is structured influences the level on which stress tests are performed. It is possible that institutions have a centralised approach to stress testing, requiring each business unit to perform the same stress tests across the group. Stresses and scenarios for capital purposes may also be run centrally based on the group's consolidated portfolio. For example integrated cross-border banks with strong centralised functions can conduct the stress testing for

the group as a whole. But it is also possible that individual business units/legal entities are run separately and produce their own ICAAP. In all cases, stress testing at the group level is greatly facilitated if the institution has an integrated approach, where stresses are consistent across the group.

30. However, under an integrated approach institutions should consider country or specific analysis in stress testing. Stress tests should be sufficiently tailored in order to cater for situations where specific markets or segments in different countries may exhibit extremely different characteristics and development stages and therefore call for different stress tests.
31. For smaller entities within large banking groups, stress testing can be performed by a specialized function at the parent level, provided the material risks of these entities are adequately captured and the local management is still aware of the risks for these entities. In such a situation, the supervisory review process with regard to stress testing will be implemented in accordance with the [CEBS guidelines on supervisory cooperation](#) for cross-border banking and investment firm groups, taking due account of the significance of the different entities within a group.

#### **III.4. Frequency and time horizon of stress testing**

***ST7. The frequency of stress testing should be determined in accordance with the nature of the risks to which the institution is exposed and the types of tests performed.***

32. To determine the frequency of stress tests, the following items can be relevant:
  - The nature of the risk drivers captured under the stress testing framework and in particular their volatility. Generally, stress testing should be conducted as frequently as necessary and any regular stress test should be performed at least once a year.
  - The techniques used by institutions while performing stress tests. In some cases, lower frequency may reflect the more complex nature of stress testing. Where the construction of hypothetical scenarios is deemed more difficult, given the time necessary to gather data for instance, the performance of such a test might be less frequent.
  - Significant changes in the external environment or in the risk profile of institutions. Irrespective of the intrinsic volatility of risk drivers, some market disruption, downgrading in the global operating environment or difficulties in specific sectors or on specific names may encourage institutions to update their stress tests or to perform them on a more frequent basis and/or to enlarge the range of assumptions.
  - The availability of the external data required to conduct the stress tests (for instance, data necessary to perform macro-economic stress tests). However, as a result of the dialogue between the

institution and the supervisor, lack of such data may not be seen as a sufficient reason to delay the implementation of stress tests or not perform them at the right frequency, unless the institution can demonstrate that it has taken reasonable steps to find alternative ways to stress test but there are no alternative ways available.

***ST8. Institutions should determine the time horizon of stress testing in accordance with the maturity and liquidity of the positions stressed where applicable.***

33. Market risk requires constant monitoring of its evolution over time (i.e. day-to-day to 10 days), while stress testing on credit risk may be conducted on the assumption of a longer holding period (i.e. several years). In general, the appropriateness of the time horizon should be determined depending on whether changes in the underlying portfolio under consideration take a longer time to implement or not (for instance the time it takes to re-balance the portfolio).

***ST9. Under specific circumstances, supervisors may require institutions to perform ad hoc stress tests at a specific point in time.***

34. In addition to the stress tests regularly performed by institutions as an integral part of their risk management, ad hoc stress tests may be required by supervisors if deemed necessary:
- To assess the impact of an observed deterioration in the environment on the financial condition of a given institution, where this situation has not been taken into account by the institution itself in its stress testing process,
  - When the supervisory assessment of the stress testing process under the SREP questions the assumptions made by the institution,
  - To assess the impact of similar stress tests across a range of institutions.
  - In doing so, supervisors would discuss with the institution the feasibility of conducting ad hoc supervisory stress tests.

### **III.5. Data quality and IT systems**

***ST10. Institutions should use appropriate and representative data when performing stress tests and the IT resources should be commensurate with the complexity of the techniques and the coverage of stress tests performed by institutions***

35. Guidance on data appropriateness, quality standards, consistency with accounting data and representativeness, as well as data sources, provided in the [CEBS Guidelines on the implementation, validation and assessment](#) of Advanced Measurement (AMA) and Internal Ratings Based (IRB) Approaches is useful in the context of stress testing. If appropriate, institutions should use day-to-day management data when performing stress tests. Where stress tests do not capture the whole portfolio, data has to be representative.
36. IT platforms, organisation and data warehousing facilities should be sufficiently sound to support the quantification and effective management of the stresses that could affect a group. In any case, institutions should assign resources adequate to the stress testing techniques implemented.
37. Section III.5 is an example of where supervisors will be mindful of the considerations presented in paragraph 5.

### **III.6. Role of the management body and senior management; reporting and interpretation of stress testing results**

38. The term 'Management body' as defined in Article 11 of the [Directive 2006/48/EC](#) should be understood to embrace different structures, such as unitary and dual board structures. In keeping with the [CEBS Guidelines on the Supervisory Review Process](#), the use of the term 'management body' does not advocate any particular board structure. The management body represents the top management level of an institution, and senior management (which is not defined in the CRD) should be understood to represent the level of management below the management body. When the CEBS Guidelines on the Supervisory Review Process identify a function of the management body, it specifies whether the reference is to the supervisory function, the management function, or both.
39. For the purpose of this Annex to the CEBS Guidelines on the Supervisory Review Process, it is not appropriate for CEBS to seek to define the responsibilities of the supervisory and management functions of the management body, because of the high degree of granularity in this Annex and the different traditions and legal frameworks in the national jurisdictions. Therefore, it is up to each national authority to define which function of the management body

is responsible for the tasks and responsibilities listed in the internal governance section below, and which internal body of the institution represents the supervisory and which the management function

***ST11. The management body has the ultimate responsibility for the overall stress testing framework. Where appropriate the management body can delegate certain aspects of this framework to specific risk committees or senior management, keeping the effective oversight.***

- Even if the identification of risk drivers obviously involves experts within the institution such as economists, traders or business managers, the involvement of the management body in the stress testing framework and of senior management in the stress testing design is essential to ensure they buy into the process. In this perspective, the management body should approve the institution's overall stress testing framework and senior management should approve the design of the sensitivity analyses or scenario tests.
- Both the management body and senior management should formally consider the results and senior management should come up with a clear understanding of their implications, keeping in mind the risk appetite of the institution. While interpreting the results, senior management should be aware of the limitations of the stress tests performed (e.g. probability of the event occurring or judgmental bias in the stress test's specification).

***ST12. The stress testing process should be an integral part of an institution's risk management framework, with clear reporting lines and communication in an understandable format.***

40. The quality of the reporting process is essential to ensure a good understanding of the stress testing results by both the management body and senior management and its ability to adopt, if necessary, appropriate action accordingly. In particular, this entails the following:

- Stress testing results should be reported to senior management and to the management body both in an appropriate form and with an appropriate frequency that allow both to consider whether the risks undertaken by the institution are consistent with the risk appetite set by it.
- The stress testing reports should provide the management body and senior management with an overview of the material risks the institution is or might be exposed to.

- Reporting may be limited to only a few of the stress tests performed by the institution. It should draw the attention to potential risks and should provide recommendations for possible remedial measures or actions when appropriate. It could in particular be necessary to mention the main assumptions of reported scenarios, include the results of previous stress tests for those performed regularly as well as the prevailing conditions as a benchmark to help decisions.

The assumptions underlying stress testing and the results should be reported to the supervisors when requested.

***ST13. Where deemed appropriate by the institution, it should take remedial measures or actions considering the level of risk exposure as revealed by stress tests and the objectives and risk tolerances defined by the management body.***

41. The management body and senior management have the responsibility to take remedial measures or actions, where deemed necessary. These measures or actions may vary depending on the circumstances, e.g.:
  - reviewing the set of limits, especially in cases where legislative requirements indicate that the results of the stress tests should be reflected in the limits set by institutions (i.e. requirements relative to market risks and to credit risk mitigation techniques),
  - recursing to risk mitigation techniques,
  - reducing exposures or business in specific sectors, countries, regions or portfolios,
  - reconsidering the funding policy,
  - reviewing capital adequacy, and
  - implementing contingency plans.

Supervisors would not necessarily expect institutions, when taking remedial measures or actions, to rely on a single and specific corrective measure.

42. On the other hand, the management body and/or senior management may decide to take no remedial measure or action to the extent that it is comfortable with the risk-return consequences stemming from the results of the stress tests.
43. Without prejudice to the responsibility of the management body and senior management to take or not to take remedial actions, where appropriate, supervisors could need to understand the rationale for the decisions taken. This discussion may be part of the dialogue under the supervisory review process. In particular, if an institution addresses the results of stress tests through taking corrective

actions, supervisory authorities could establish whether (i) such actions will be available in a period of stress and (ii) the institution will be able and willing to take such actions. An indicator for the credibility of such actions could be that the institution has in the past taken similar measures.

44. Decisions relative to remedial measures or actions taken by the management body or the senior management within the ICAAP process should be documented (e.g. minutes of the relevant Committee).

***ST14. Appropriate documentation should be in place to facilitate the adequate implementation of the whole stress testing framework.***

45. As indicated in CEBS's guidelines on the application of the supervisory review process, the institution's objectives, risk strategies and policies adopted to achieve these objectives should be clearly defined in a written document approved by the management body or a designated committee thereof. As far as the stress testing process is concerned, all material information (e.g. scope of exposure, underlying assumptions, responsibilities, reporting lines and types of remedial measures and actions) should be appropriately documented.

### **III.7. Review and update of stress testing methodology**

***ST15. Institutions should consider periodically whether stress tests are still adequate. In particular, institutions should ensure that assumptions regarding the risk profile and the external environment are still valid over time.***

46. The institution should conduct an assessment of the adequacy of the stress tests particularly in the light of changes in portfolio characteristics or in the external environment once a year, and on a more frequent basis where the risk profile of the institution changes quickly. In particular, this internal assessment should consider the relevance of the following:
  - the scope of exposures captured under the stress testing process,
  - the validity of the assumptions,
  - the adequacy of the management information system,
  - the integration into the institution's management processes, including the clarity of reporting lines,
  - the approval policy of the stress testing process (including in case of changes),
  - the reliability, accuracy and completeness of data incorporated into the stress testing process, and
  - the quality of the documentation of the stress testing process.

## IV. Stress testing guidelines by risk categories

47. The following section details some of the stress test requirements of the CRD elaborating specific guidelines for macroeconomic stress testing and stress testing by risk categories (market risk, liquidity risk and credit risk) and, where necessary, considers the interaction between Pillar 1 and Pillar 2 stress testing. Stress tests on the Interest Rate Risk in the Banking Book are dealt with in CEBS Guidelines on technical aspects of the management of interest rate risk arising from non trading activities and concentration risk under the supervisory review process. These guidelines do not give any guidance on counterparty credit risk with respect to trading book activities following the so-called 'Trading book review'.
48. This section is not meant to provide a supervisory checklist of stress tests that should be performed by institutions, but to promote practical criteria to be used by supervisors when discussing specific stress tests carried out by institutions under the supervisory review process. As mentioned in the executive summary of these guidelines, proportionality concerns as well as the dialogue with the institutions are key in this process. Examples given below are for illustrative purposes only.

### IV.1. Macro-economic stress tests

49. Under Annex V Paragraph 2 of the [Directive 2006/48/EC](#), institutions should manage, monitor and mitigate the risks they are or might be exposed to, including those posed by the macro-economic environment in which they operate in relation to the position in the business cycle.

***ST16. In line with one of the CEBS's High Level Principles listed in the CEBS Guidelines on the Supervisory Review Process (ICAAP 8) institutions should use stress testing as one (among others) tool to assess the risks in a forward looking manner.***

50. Taking into account the principles set out in section III.1 of this paper, the decision on which risk categories and to what extent macro-economic stress-testing is applied is within the institution's own responsibility. An institution should carry out its capital assessment taking into account its future business plans. This is because certain strategies may need to be adequately funded by the institution in advance of their implementation.
51. In doing so, an institution should consider the effects of macro-economic factors on its capital and, to the extent possible, on earnings and whether they could affect its strategic plans. For instance, an institution may like to explore the effects an economic downturn will have on its portfolio and assess the impact on its

current level of capital should it want to achieve its strategic objectives under such stressed conditions. If applicable, macro-economic scenarios or stresses should be sufficiently granular to simulate each material risk the institution has previously identified as part of its internal capital assessment. Macro-economic scenarios or stresses should be of a magnitude equivalent to an exceptional but plausible event.

## **IV.2. Market Risk**

### **IV.2.a. General principles**

52. Under paragraph 10 of Annex V of the [Directive 2006/48/EC](#), all institutions, irrespective of the method used for the calculation of capital requirements for market risks, shall implement policies and processes for the measurement and management of all material sources and effects of market risks.

***ST17. As part of these policies and processes, institutions should conduct stress tests for their positions in financial instruments in the trading book.***

- If applicable, institutions should consider a range of exceptional but plausible market shocks or scenarios for their trading book positions. In particular, “exceptional” changes in market prices, shortages of liquidity in the markets and defaults of large market participants have to be taken into account. Dependencies between different markets should also be factored in.
- The stress tests applied and the calibration of those tests should reflect the nature of the portfolios, the trading strategies of the institution and the time it could take to hedge out or manage risks under severe market conditions. As their instruments and trading strategies change, the stress tests should also evolve to accommodate the changes.

### **IV.2.b Principles for institutions using an internal model for the calculation of their market risk minimum capital requirements**

53. Under Annex V of the Directive 2006/49/EC, institutions applying for the use of internal models to calculate capital requirements for market risks shall frequently conduct a rigorous programme of stress testing, the results of which shall be reviewed by senior management and reflected in the policies and limits it sets. Depending on the nature of the portfolio the stress tests could factor in (where applicable):

- illiquidity/gapping of prices (including interest rates and exchange rates),

- concentrated positions (in relation to market turnover),
- one-way markets,
- non-linear products / deep out-of-the-money positions,
- events and jumps-to-default, and
- significant shifts in correlations and volatility.

In particular, they should cover other risks that may not be captured appropriately in the minimum capital requirements for market risks (such as recovery rate uncertainty, implied correlations or skew risk).

***ST18. For those institutions using internal models for the calculation of regulatory capital requirements for market risks, supervisory requirements for stress testing remain unchanged. Their on-going fulfilment will be considered under the SREP.***

54. For institutions that are allowed to apply internal models where the regulatory capital is calculated under a more risk sensitive approach being assessed against a 10 day time horizon and 99 percentile confidence level, it is important that tail events beyond that confidence level, such as those noted in the section above, are considered. Based on current guidelines, a rigorous stress testing programme should satisfy the following criteria:

- all material risk drivers which could entail extraordinarily large losses, or which could severely hamper risk management, should be encompassed. Those factors include events with low probability for all main risk types, especially the various components of market risks. The impact of stress situations on both linear and non linear products should be captured. The tests should be applied at an appropriate level, as defined by the institution.
- the programme should assess the consequences of major market disturbances and identify plausible situations which could entail extraordinarily high losses. At portfolio level, the effects of changed correlations should be explored. Mitigating effects as consequences of contingency plans may be taken into account if the plans are based on plausible assumptions about market liquidity.
- the programme should encompass situations identified by institutions as exceptional but plausible based on their portfolios' characteristics.
- institutions should list the measures taken to reduce their risks and preserve their own funds. In particular, limits on exchange rate, interest rate, equity price and commodity price risks set by institutions should be checked against the results of the stress testing calculations.

55. Bearing in mind the results of stress testing, supervisors may consider whether an institution has sufficient own funds to cover the minimum capital requirements, taking into account the nature and scale of the institution's trading activities and any other relevant factors, such as valuation adjustments made by the institution.

### **IV.3. Credit risk stress testing**

56. Discussions on stress testing for credit risk often focus on stress testing for IRB institutions. However, Pillar 2 ICAAP requires all institutions to assess and manage their capital adequacy in a forward looking manner. Therefore, credit risk concentration stress tests also play an important role here.

#### **IV.3.a. Concentration Risk**

57. The following detailed guidance focuses on one specific aspect of concentration risk only, i.e. the financial collateral values in connection with large exposures. A broader approach to stress testing on concentration risk is addressed in the CEBS Guidelines on technical aspects of the management of interest rate risk arising from non-trading activities and concentration risk within Pillar 2.
58. Article 114 (3) of the Directive 2006/48/EC requires that institutions using exposure values calculated according to the financial collateral comprehensive method under Articles 90 to 93 and Annex VIII for identifying large exposures (LE), as defined by Article 111, or recognising the effects of financial collateral estimated separately from other LGD relevant aspects for identifying large exposures, shall periodically perform a stress test of their credit risk concentrations including the impact on the realisable value of any collateral taken in stressed situations. Where the results of this test indicate a lower realisable value in times of stress, an institution shall adjust the value of collateral taken into account when calculating the value of exposures for its LE limit. As an alternative, it could consider taking additional financial collateral.

***ST19. Institutions under the large exposures provisions using the comprehensive method for calculating the effects of financial collateral, or permitted to use their own estimates of LGDs and conversion factors, should identify conditions which would adversely affect the realisable value of their financial collateral***

59. Although the CRD is silent as to the form, such market conditions may include downturn scenarios or other events which may affect the realisation of the collateral's estimated value, such as a decrease in credit quality of the collateral issuers or market illiquidity which impacts the liquidation period taken into account when calculating the effects of financial collateral for those institutions using the comprehensive method based either on the supervisory volatility adjustments or on their own estimates of volatility adjustments.

60. The potential for such events to occur may be determined by institutions based on the type of financial collateral used. Different assumptions may legitimately be used between sovereign debt collateral and equities/convertible bonds collateral. Other examples which may affect the financial collateral's estimated value include currency mismatch between exposure and financial collateral, arrangements for marking to market and the realisation of value from large amounts of financial collateral from a single source in a 'distressed sale'.
61. When considering a downturn, institutions may also find it useful to consider a 'mild recession' scenario as per [Directive 2006/48/EC](#), annex 7, part 4, paragraph 41 as one market condition which could have a detrimental effect on own funds.
62. An institution should conduct the stress test as frequently as its risk profile demands.

***ST20. According to Article 114 (3) of the Directive 2006/48/EC, where the results of the stress testing indicate a lower realisable value of collateral, the value of collateral taken into account for the purpose of determining an institution's LE limits should be adjusted accordingly.***

63. To avoid such adjustments institutions may think it prudent to ensure that an appropriate margin over the collateralised exposure is maintained. This would cover fluctuations in the market value of the collateral to ensure that it does not fall below the reported level.

#### **IV.3.b. Stress testing for IRB institutions**

64. According to Annex XI paragraph 1a of the Directive 2006/48/EC, the review and evaluation performed by competent authorities pursuant to Article 124 shall include the results of the stress tests carried out by the credit institutions applying an IRB approach. These institutions are subject to specific provisions in Annex VII Part 4 of the Directive 2006/48/EC, Section 1.8, Paragraphs 40 to 42 and Paragraph 114.
65. Furthermore, according to Article 84 (2) of the Directive 2006/48/EC, institutions shall only be given permission to calculate their risk weighted exposure amounts using the IRB approach if the competent authority is satisfied that the credit institution's systems for the management and rating of credit risk exposures meet the minimum requirements of Annex VII Part 4 of the Directive 2006/48/EC.
66. Paragraph 40 of Annex VII Part 4 requires institutions to examine potential unfavourable effects on their credit exposures and their "ability to withstand such changes" by means of stress testing.

67. As for the purpose of paragraph 40, the “ability to withstand such changes” means amongst other measures that the institution’s available capital resources cover credit risks for the credit portfolio derived from a particular stress scenario. Stress testing in this case consists of “identifying possible events or future changes in economic conditions that could have unfavourable effects on an institution’s credit exposures”.
68. By contrast, the paragraph 41 stress test is designed to address the effect of certain specific conditions, including at least mild recession scenarios, on its total capital requirements for credit risk. Since those capital requirements could change dependent on the stage within the economic cycle, those stress tests should show the potential impact on capital requirements. The stress tests could thus show the need for possible action on the part of the institution, including the possible need for an increase in own funds.
69. Because minimum capital requirements for credit risk may be dependent on certain specific economic conditions, paragraph 41 requires institutions to conduct a stress test on the impact of at least a mild recession, on their regulatory IRB capital requirement. This aims to assess an institution’s ability to continue to meet its Article 75 credit risk capital requirements.
70. Given the above, a suitable macro-economic scenario covered by this stress test should be at least a mild recession but may go further, assessing the impact of ratings migration on capital requirements with respect to the economic cycle. This could include a significant and sustained deterioration in the economic climate. To this end, institutions should consider a range of stress tests and scenario analysis.
71. It is up to institutions to determine how this translates into specific risk drivers and how these risk drivers in turn affect an institution’s total capital requirements for credit risk. Institutions may find it helpful to develop these linkages on an asset by asset class basis (for example, factors relevant to mortgages may be different to corporate asset classes).
72. Where an institution has numerous businesses, questions of diversification may arise, particularly across different geographic areas which may be subject to economic conditions that are not synchronised. Therefore it is not necessarily assumed that the aggregated impact is equal to the simple sum of each business's figures. However, in the spirit of the test, institutions should apply reasonable conservatism in specifying correlations and be able to justify their choices.
73. These stress tests should be undertaken at least annually. This aims to ensure that stress testing becomes a useful tool to both institutions and the supervisors in anticipating changes to the level of regulatory capital requirements for credit risk and therefore encourage good risk management.

74. The result of the stress test has no direct effect on the Article 75 requirement and does not necessarily mean an additional requirement (i.e. extra capital or other measures), for example to the extent that:
- institutions are dealing with products or counterparties that can be shown to be countercyclical,
  - institutions can demonstrate credible management actions which can counter potential capital deficits (see section III.6 of this paper), or
  - if the economy is already in a recession.
75. However, under the supervisory review process, to the extent that the stress test indicates a deficit, among other measures additional capital may be required.
76. The function responsible for IRB stress testing could be the Credit Risk Control function (as defined in the CEBS Guidelines on the implementation, validation and assessment of AMA and IRB approaches) in order to maintain the objectivity of stress testing. Another reason is that, among the activities to be performed by the Credit Risk Control Unit, there are some that, to some extent, refer to stress testing (see paragraph 128 of Annex VII, Part IV)
77. There is no expectation that the stress tests referred to in paragraph 40 or 41 will necessarily produce an LGD that is either lower than, or higher than, the LGD estimated according to Annex VII, part 4, paragraph 73. To the extent that the identification of downturn periods under paragraph 73 coincides with the stress tests in paragraph 40 or 41, the calculation might turn out to be similar. More generally, some stress test calculations under paragraph 40 or 41 may function as one tool for assessing the robustness of the LGD estimation under paragraph 73. For further details refer to the CEBS Guidelines on the implementation, validation and assessment of AMA and IRB approaches.
78. For the purpose of calculating capital requirements, according to Annex VII, Part 4, Paragraph 115 g) of the [Directive 2006/48/EC](#) (referring specifically to the equity portfolio) institutions shall have a rigorous and comprehensive stress-testing programme in place. Since this is a particularly narrow stress test which applies only to IRB firms using the modelling approach to equity and since there will probably be only a few institutions applying this approach no further guidelines apart from the general ones given in Sections I to III are given at this stage.

#### **IV.4. Liquidity risk**

79. According to Annex V paragraph 14 of the Directive 2006/48/EC, institutions shall have in place policies and processes for the measurement and management of their liquidity risk on an on-going and forward-looking basis. To this end, "alternative scenarios shall be

considered and the assumptions underpinning decisions concerning the net funding position shall be reviewed regularly". According to Paragraph 15 contingency planning to deal with liquidity crises shall also be in place. This section elaborates on some principles and criteria to review the adequacy of stress testing with respect to liquidity risk (understood primarily as funding risk) under Pillar 2, in line with this legislative requirement.

***ST21. Institutions should regularly project cash flows under alternative scenarios of various degrees taking into account both market liquidity (external factors) and funding liquidity (internal factors)***

80. Institutions should be prepared to manage liquidity under stressed conditions. Though scenario design is the responsibility of each institution depending on its risk profile, institutions should project cash inflows and outflows considering both market-wide and institution-specific difficulties. For illustrative purpose, examples of such scenarios are provided in Annex 1. Institutions that are part of a wider group may evaluate scenarios on a global or regional basis if they can demonstrate the appropriateness of such a decision.

***ST22. When assessing the impact of these scenarios on their cash flows, institutions should rely on a set of reasonable assumptions that should be reviewed regularly.***

81. Examples for what features these assumptions could possibly capture are presented in Annex 1.
82. Different techniques may be used by institutions to derive cash inflows and outflows under stress such as the use of historical patterns, statistical modelling, judgmental projections or a combination of these. Notwithstanding the techniques used – but especially where judgmental projections have a leading role – assumptions should be assessed frequently to determine their continuing validity.

***ST23. Institutions should have in place adequate contingency plans in the event of the realisation of a liquidity crisis.***

83. Contingency plans may differ across institutions depending for example on the extent to which they rely on external parties in a stressful situation. The adequacy of these plans will be reviewed by supervisors. Examples for elements of a contingency plan are provided in Annex 1.

***ST24. To come up with a complete view of various risk positions, stress testing of other risk types may be usefully considered to design "alternative liquidity scenarios".***

84. Some useful information for “alternative liquidity scenarios” may stem from stress testing in other areas such as market risk, credit risk, reputation risk or operational risk. Reputation risk might be an important trigger of adverse liquidity conditions since it interacts with the optionality granted to counterparties. Operational risk may also be a source of liquidity disruptions (for instance, an event in a major financial centre).

***ST25. Supervisors may perform their own stress tests based on available data in their assessment of liquidity risk under SREP.***

85. For internal purposes supervisors may design specific stress scenarios based on available information previously reported by institutions subject to some quantitative requirements relating to liquidity. Such scenarios may, in particular, incorporate conservative assumptions to test, for instance, the ability of the institution to withstand a downgrade using its available liquidity resources. In such a case, supervisors may apply different discount factors to assets considered as liquid and conservative behavioural assumptions for saving and sight deposits.

**V. Considerations for other risk categories.**

86. Article 123 of the [Directive 2006/48/EC](#) requires that credit institutions when conducting the ICAAP have to consider the “nature and level of the risks to which they are or might be exposed”. If the level of risk of a specific category is material enough to make the institution vulnerable with respect to this risk, the institution has to take the risk into account when assessing the adequacy of its internal capital. However, some risks are more qualitative in nature and therefore cannot be measured exactly. This can be due to the nature of the risk or a low level of sophistication with respect to risk measurement within the institution. Nevertheless, CEBS Guidelines on the Application of the Supervisory Review Process state that risks which are not precisely quantifiable should be included in the ICAAP if they are material.<sup>131</sup> Stress testing according to Section III of these guidelines could be a means to arrive at such an assessment. Examples of such “impossible to be modelled exactly” risks could be risks specific to certain jurisdictions, some kinds of operational risk (e.g. legislative risk), reputation risk or strategic risk.

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<sup>131</sup>However, see ICAAP 9 lit. g. 2nd sentence of CEBS Guidelines on the Application of the Supervisory Review Process.

## Annexes

### Annex 1: Examples concerning liquidity risk

1. Some examples for elements concerning scenarios for projecting cash inflows and outflows considering both market-wide and institution-specific difficulties are the following:

To test market illiquidity or system-wide events, scenarios may assume:

- interbank market difficulties,
- the withdrawal of a major market player from a particular market,
- illiquidity in specific markets (e.g. crisis in emerging countries), and
- distress of specific currencies important for the institution's funding.

To test institution-specific liquidity distress, scenarios may assume:

- a downgrade of its own rating or an expectation of a downgrade leading to an increase in funding cost,
- a sharp increase in the drawdown of commitments by borrowers,
- a sudden change in the composition of deposits and a sudden increase of cash deposit withdrawals, and
- a tightening of credit lines.

2. Examples for reasonable assumptions when assessing the impact of these scenarios on the cash flows are:

- the institution's projected stock of potential assets,

Institutions could consider (i) the expected proportion of maturing assets that will be roll-over, (ii) the expected amount of new loans that will be approved, and (iii) the level of draw downs of commitments to lend that the institution will need to fund.

- the cash flows arising from the institution's liabilities under stress conditions,

These may be derived in comparison with the cash flows that normally arise (i.e. given the level of roll-overs, the effective maturity of liabilities with non-contractual maturity and the growth of

deposits). Assumptions on the liability side are likely to determine (i) the stable sources of funding in cases of stress, (ii) the potential run-off of liabilities with non-contractual maturities, (iii) the potential exercise of options giving counterparties the right to withdraw funds immediately, as well as (iv) the potential use of back-up facilities.

- the market perception of the institution and its access to the markets.

This may include assumptions relative to the institution's access to OTC derivative and foreign exchange markets, as well as its access to secured funding, including by way of repo transactions. Securitisation may be also considered to assess potential triggering of early amortisation. Institutions may also estimate their capacity to sell assets including the terms of such sales (e.g. discounts).

3. Examples for elements of a contingency plan are:

- definition of the events triggering the plan,
- a description of the potential sources of funding either on the asset or on the liabilities side (e.g. slowing loan growth, sale or repo of liquid assets, securitisation, subsidiary sales, increasing deposit growth, lengthening maturities of its liabilities as they mature, draw-down of committed facilities, capital raising, stopping dividends to parents),
- an escalation procedure detailing how additional funds could be raised,
- a procedure for the smooth management of the contingency, which should include a description of the delineation of responsibilities (including the responsibilities of the management body) and a process to ensure timely information flow (for instance through contact lists), and
- a procedure to guide potential contacts with external parties such as important counterparties, auditors, analysts, media or supervisory authorities.

## Annex 2

### LIST OF RELEVANT PROVISIONS FROM THE CAPITAL REQUIREMENTS DIRECTIVES (including trading activities related issues and the treatment of double default effects)

#### [Directive 2006/48/EC](#)

##### ***Article 114. CRM eligibility for large exposures. Collateral value in stressed situations***

(...)

3. A credit institution which is permitted to use the methods described in paragraphs 1 and 2 in calculating the value of exposures for the purposes of Article 111(1) to (3) shall conduct periodic stress tests of their credit risk concentrations including in relation to the realisable value of any collateral taken.

These shall address risks arising from potential changes in market conditions that could adversely impact the credit institutions' adequacy of own funds and risks arising from the realisation of collateral in stressed situations

The credit institution shall satisfy the competent authorities that the stress tests carried out are adequate and appropriate for the assessment of such risks.

In the event that such a stress test indicates a lower realisable value of collateral taken than would be permitted to be taken into account under paragraphs 2 and 3 as appropriate, the value of collateral permitted to be recognised in calculating the value of exposures for the purposes of Article 111(1) to (3) shall be reduced accordingly.

##### ***Annex V. Technical criteria on the treatment on organisation of risks***

(...)

2. The management body referred to in Article 11 shall approve and periodically review the strategies and policies for taking up, managing, monitoring and mitigating the risks the credit institution is or might be exposed to, including those posed by the macroeconomic environment in which it operates in relation to the status of the business cycle.

(...)

#### 10. Liquidity risk

14. Policies and processes for the measurement and management of their net funding position and requirements on an ongoing and forward-looking basis shall exist. Alternative scenarios shall be considered and the assumptions underpinning decisions concerning the net funding position shall be reviewed regularly.

15. Contingency plans to deal with liquidity crises shall be in place.

#### ***Annex VII. Part 4. Stress tests according to minimum requirements for IRB Approach***

(...)

#### 1.8. Stress tests used in assessment of capital adequacy

40. A credit institution shall have in place sound stress testing processes for use in the assessment of its capital adequacy. Stress testing shall involve identifying possible events or future changes in economic conditions that could have unfavourable effects on a credit institution's credit exposures and assessment of the credit institution's ability to withstand such changes.

41. A credit institution shall regularly perform a credit risk stress test to assess the effect of certain specific conditions on its total capital requirements for credit risk. The test to be employed shall be one chosen by the credit institution, subject to supervisory review. The test to be employed shall be meaningful and reasonably conservative, considering at least the effect of mild recession scenarios. A credit institution shall assess migration in its ratings under the stress test scenarios. Stressed portfolios shall contain the vast majority of a credit institution's total exposure.

42. Credit institutions using the treatment set out in Part 1, point 4 shall consider as part of their stress testing framework the impact of a deterioration in the credit quality of protection providers, in particular the impact of protection providers falling outside the eligibility criteria.

#### ***Annex VII. Part 4. LGD and Conversion Factors estimates under IRB***

(...)

74. Credit institutions shall use LGD estimates that are appropriate for an economic downturn if those are more conservative than the long-run average. To the extent a rating system is expected to deliver constant realised LGDs by grade or pool over time, credit institutions shall make adjustments to their estimates of risk parameters by grade or pool to limit the capital impact of an economic downturn.

(...)

88. Credit institutions shall use conversion factor estimates that are appropriate for an economic downturn if those are more conservative than the long-run average. To the extent a rating system is expected to deliver constant realised conversion factors by grade or pool over time, credit institutions shall make adjustments to their estimates of risk parameters by grade or pool to limit the capital impact of an economic downturn.

***Annex VII. Part 4. Stress testing requirements for Value-at-risk models for equity exposures under the Internal models approach.***

115. For the purpose of calculating capital requirements credit institutions shall meet (for the equity portfolio) the following standards: (...)

g) A rigorous and comprehensive stress-testing programme shall be in place.

***Annex VII. Part 4. Corporate Governance requirements***

(...)

127. Internal ratings-based analysis of the credit institution's credit risk profile shall be an essential part of the management reporting to these parties. Reporting shall include at least risk profile by grade, migration across grades, estimation of the relevant parameters per grade, and comparison of realised default rates and own estimates of LGDs and conversion factors against expectations and stress-test results. Reporting frequencies shall depend on the significance and type of information and the level of the recipient.

***Annex VIII. Part 3. Stress testing with respect to Internal models approach for calculating fully adjusted exposure value for exposures subject to master netting agreements (under CRM rules).***

(...)

16. Recognition shall only be given if the competent authority is satisfied that the credit institution's risk-management system for managing the risks arising on the transactions covered by the master netting agreement is conceptually sound and implemented with integrity and that, in particular, the following qualitative standards are met:

(g) the credit institution frequently conducts a rigorous programme of stress testing and the results of these tests are reviewed by senior management and reflected in the policies and limits it sets;

(...)

***Annex VIII Part 3. Own estimates of volatility adjustments under the Financial Collateral Comprehensive Method***

50. Credit institutions shall take into account the illiquidity of lower-quality assets. The liquidation period shall be adjusted upwards in cases where

there is doubt concerning the liquidity of the collateral. They shall also identify where historical data may understate potential volatility, e.g. a pegged currency. Such cases shall be dealt with by means of a stress scenario.

***Annex XI. Stress testing under the SREP by the competent authorities.***

1. In addition to credit, market and operational risk, the review and evaluation performed by competent authorities pursuant to Article 124 shall include the following:

(a) the results of the stress test carried out by the credit institutions applying an IRB approach;

(b) the exposure to and management of concentration risk by the credit institutions, including their compliance with the requirements laid down in Articles 108 to 118;

(c) the robustness, suitability and manner of application of the policies and procedures implemented by credit institutions for the management of the residual risk associated with the use of recognized credit risk mitigation techniques;

(d) the extent to which the own funds held by a credit institution in respect of assets which it has securitised are adequate having regard to the economic substance of the transaction, including the degree of risk transfer achieved;

(e) the exposure to and management of liquidity risk by the credit institutions.

(f) the impact of diversification effects and how such effects are factored into the risk management system

(g) the results of stress tests carried out by institutions using an internal model to calculate market risk capital requirements under Annex V of Directive [2006/49/EC]

**[Directive 2006/49/EC](#)**

***Annex V. Use of Internal Models to calculate capital requirements for market risks***

(...)

2. Recognition shall only be given if the competent authority is satisfied that the institution's risk-management system is conceptually sound and implemented with integrity and that, in particular, the following qualitative standards are met: (...)

g) the institution frequently conducts a rigorous programme of stress testing and the results of these tests are reviewed by senior management and reflected in the policies and limits it sets. This process shall particularly address illiquidity of markets in stressed market conditions, concentration risk, one way markets, event and jump-to-default risks, non-linearity of products, deep out-of-the-money positions, positions subject to the gapping of prices and other risks that may not be captured appropriately in the VaR model. The shocks applied shall reflect the nature of the portfolios and the time it could take to hedge out or manage risks under severe market conditions; (...)

**Trading book review (trading activities related issues and the treatment of double default effects)**

***Annex III. EPE (Expected Positive Exposure Models). Stress testing as a supplement to counterparty credit risk***

(...) Part 6

24. A credit institution shall have a routine and rigorous program of stress testing in place as a supplement to the CCR analysis based on the day-to-day output of the credit institution's risk measurement model. The results of this stress testing shall be reviewed periodically by senior management and shall be reflected in the CCR policies and limits set by management and the board of directors. Where stress tests reveal particular vulnerability to a given set of circumstances, prompt steps shall be taken to manage those risks appropriately.

(...)

32. A credit institution shall have in place sound stress testing processes for use in the assessment of capital adequacy for CCR. These stress measures shall be compared with the measure of EPE and considered by the credit institution as part of the process set out in Article 123. Stress testing shall also involve identifying possible events or future changes in economic conditions that could have unfavourable effects on a credit institution's credit exposures and an assessment of the credit institution's ability to withstand such changes.

33. The credit institution shall stress test its CCR exposures, including jointly stressing market and credit risk factors. Stress tests of CCR shall consider concentration risk (to a single counterparty or groups of counterparties), correlation risk across market and credit risk and the risk that liquidating the counterparty's positions could move the market. Stress tests shall also consider the impact on the credit institution's own positions of such market moves and integrate that impact in its assessment of CCR.

## Guidelines on Outsourcing<sup>132</sup>

CEBS presents its Guidelines on Outsourcing. The proposed guidelines are based on current practices and also take into account international, such as the Joint Forum, and European initiatives in the field of outsourcing. Following comments received during the first round of consultation, CEBS and the Committee of European Securities Regulators (CESR) have ensured that the proposed guidelines are consistent with the [Markets in Financial Instruments Directive \(MiFID\)](#) and its application to credit institutions.

### ***Introduction***

There is currently no harmonisation at the EU level in the area of outsourcing undertaken by credit institutions and, accordingly, different supervisory approaches have developed across the EU to address the potential risks arising from this practice. A number of European countries have, for some years, had in place formal outsourcing regimes. Given the increasing use of outsourcing by institutions, including on a cross-border basis, and its implications for effective prudential supervision, CEBS has deemed it appropriate to develop these Guidelines in order to promote greater consistency of approach where possible within the national legal frameworks. The Guidelines are based on a range of current practices and the common elements of policy that have been elaborated to date in various Member States but also take into account various recent international and European initiatives in the field of outsourcing.

There is an obvious overlap between the proposed guidelines, on the one hand, and relevant MiFID rules, and the ensuing level 2 measures that will apply to all authorized entities offering investment services under the MiFID, on the other hand. CEBS and CESR have duly consulted to ensure that the proposed guidelines:

- are in full compliance with the MiFID level 2 provisions and that their application to credit institutions subject to MiFID is fully consistent; and
- are consistently applied to all credit institutions, thus contributing towards establishing a level playing field for them.

These Guidelines are designed to promote an appropriate level of convergence in supervisory practices throughout the EU. At the same time, the Guidelines are principles-based and provide national supervisors

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<sup>132</sup> As to the history of the guidelines on outsourcing, the document published on the CEBS website can be found under the following link: <http://www.c-eps.org/documents/Publications/Standards---Guidelines/files-from-old-website/GL02OutsourcingGuidelines-pdf.aspx>

with an adequate degree of flexibility to take into account domestic rules and specific features of their local markets and to accommodate developments in market practices.

The concept of proportionality, as laid down in the provisions of the [Directive 2006/48/EC](#) applies also to outsourcing and its policy which will be expected to be related to the size of the institutions as well as to the sophistication and diversification of the outsourced activities. supervisory authorities will adapt their approach to outsourcing to ensure it is proportionate to the nature, scale and complexity of the outsourced activities of an institution.

## **Part 1: Definitions**

### **Guideline 1**

For the purposes of these guidelines, the following is meant by:

- a. outsourcing: an authorised entity's use of a third party (the "outsourcing service provider") to perform activities that would normally be undertaken by the authorised entity, now or in the future. The supplier may itself be an authorised or unauthorised entity;
- b. purchasing: *inter alia*, the supply (i) of services, goods or facilities without information about, or belonging to, the purchasing institution coming within the control of the supplier; or (ii) of standardized products, such as market information or office inventory. (Authorised entities should ensure that what they are buying is fit for purpose.). The supply of (i) or (ii) is not outsourcing;
- c. outsourcing service provider: the supplier of goods, services or facilities, which may or may not be an authorised entity, and which may be an affiliated entity within a corporate group or an entity that is external to the group;
- d. outsourcing institution: the authorised entity which is the buyer of such goods, services or facilities;
- e. authorised entity: a licensed credit institution;
- f. material activities: (i) activities of such importance that any weakness or failure in the provision of these activities could have a significant effect on the authorised entity's ability to meet its regulatory responsibilities and/or to continue in business; (ii) any other activities requiring a licence from the supervisory authority; (iii) any activities having a significant impact on its risk management; and (iv) the management of risks related to these activities.

- g. senior management: persons who effectively direct the business of the authorised entity;
- h. "chain" outsourcing: outsourcing where the outsourcing service provider subcontracts elements of the service to other providers.

**Part 2:**

***Guidelines on outsourcing addressed to authorised entities***

**Guideline 2**

**The ultimate responsibility for the proper management of the risks associated with outsourcing or the outsourced activities lies with an outsourcing institution's senior management.**

1. All outsourcing regimes should ensure that the outsourcing of functions to an outsourcing service provider does not impair the supervision of the outsourcing institution.
2. Responsibility for outsourced functions must always be retained by the outsourcing institution. The outsourcing of functions does not relieve an outsourcing institution of its regulatory responsibilities for its authorized activities or the function concerned.
3. Outsourcing institutions should be required to retain adequate core competence at a senior operational level in house to enable them to have the capability to resume direct control over an outsourced activity, in extremis.
4. Outsourcing shall not affect managers' full and unrestricted responsibilities under applicable legislation (e.g. under banking law).

**Guideline 3**

**Outsourcing arrangements can never result in the delegation of senior management's responsibility.**

1. The outsourcing of core management functions is considered generally to be incompatible with the senior management's obligation to run the enterprise under their own responsibility. Core management functions include, inter alia, setting the risk strategy, the risk policy, and, accordingly, the risk-bearing capacity of the institution. Hence, management functions such as the setting of strategies and policies in respect of the authorised entity's risk profile and control, the oversight of the operation of the entity's processes,

and the final responsibility towards customers and supervisors should not be outsourced.

#### **Guideline 4**

**4.1 An authorised entity may not outsource services and activities concerning the acceptance of deposits or to lending requiring a licence from the supervisory authority according to the applicable national banking law unless the outsourcing service provider either (i) has an authorisation that is equivalent to the authorisation of the outsourcing institution; or (ii) otherwise allowed to carry out those activities in accordance with the relevant national legal framework.**

**4.2 Any area of activity of an outsourcing institution other than those identified in Guidelines 2 and 3 may be outsourced provided that such outsourcing does not impair:**

- a. the orderliness of the conduct of the outsourcing institution's business or of the financial services provided;
- b. the senior management's ability to manage and monitor the authorised entity's business and its authorised activities;
- c. the ability of other internal governance bodies, such as the board of directors or the audit committee, to fulfil their oversight tasks in relation to the senior management; and
- d. the supervision of the outsourcing institution.

**4.3 An outsourcing institution should take particular care when outsourcing material activities. The outsourcing institution should adequately inform its supervisory authority about this type of outsourcing.**

1. These requirements do not affect the principle of managers' sole responsibility (Guideline 2) for all authorised activities. The managers of the outsourcing institution shall be fully responsible to the supervisory authority for any outsourced activity. The managers should therefore take suitable measures to ensure that the outsourced activities continue to meet the performance and quality standards that would apply if their own institution were to perform the relevant activities in-house.
2. An outsourcing institution should adequately inform its supervisory authority on any material activity to be outsourced. Such information should be made available in a timely manner in order for the supervisor to evaluate the proposal or to allow him to consider whether the proposal raises prudential concerns and to take

appropriate action if required. Outsourcing institutions should be aware that for the outsourcing of material activities the supervisory authority may impose specific conditions. In doing so, the supervisory authority will consider factors such as the size of the institution, the nature of the outsourced activity, the characteristics and market position of the service provider, the duration of the contract and the potential of the outsourcing to generate conflicts of interest (e.g. the supervisory authority may wish to prohibit the outsourcing of the financial accounting and the preparation of the annual accounts to the outsourcing institution's external auditor, or to the office with which the external auditor is connected).

3. An outsourcing institution should inform its supervisory authority of any material development affecting the service provider and its ability to fulfil its obligations to customers.
4. Subject to the principles that apply to cross-border outsourcing expressed under Guideline 4.1(i), no special rules are needed in relation to the geographical location of an outsourcing service provider. However, due to possible data protection risks and risks to effective supervision by the supervisory authority, institutions should take special care when entering into and managing outsourcing agreements that are undertaken outside the EEA.
5. Intra-group outsourcing and outsourcing according to Guideline 4.1(i) can be material. Outsourcing institutions should be aware that supervisory authorities may take specific circumstances into consideration, such as the extent to which the outsourcing institution controls the service provider or has the ability to influence its actions, and the extent to which the service provider is included in the consolidated supervision of the group, when assessing the risks associated with an intra-group outsourcing arrangement and the treatment to apply to such arrangements.

## **Guideline 5**

**There should be no restrictions on the outsourcing of non-material activities of an outsourcing institution.**

1. In such cases the outsourcing institution does not need to adequately inform its supervisory authority. Nevertheless, outsourcing institutions should adequately manage the risks relating to such outsourcing arrangements at all times. In line with Guideline 2, the senior management of the outsourcing institution should be fully responsible for any outsourced activity.
2. Areas which could be regarded as non-material are those not falling within the definition of "material activities" according to Guideline 1(f), and may include:

- a. areas which do not potentially constitute relevant risks and which, if outsourced, would not compromise the provisions set forth in Guideline 4.2 above; and
- b. purely advisory services used by the institution. For example, this applies to legal and tax consulting, even where this is not limited to individual aspects or projects.

## Guideline 6

**6.1 The outsourcing institution should have a policy on its approach to outsourcing, including contingency plans and exit strategies.**

**6.2 An outsourcing institution should conduct its business in a controlled and sound manner at all times.**

1. The outsourcing institution should have a general policy that covers all aspects of outsourcing, including non-material outsourcing, whether the outsourcing takes place within a corporate group or not.
2. When drawing up the policy the outsourcing institution should recognise that no form of outsourcing is risk free. The policy should recognise that the management of non-material and intra-group outsourcing should be proportionate to the risks presented by these arrangements.
3. The policy should explicitly consider the potential effects of outsourcing on certain significant functions (e.g. the internal audit function and the compliance function) when conducting the risk analysis prior to outsourcing.
4. The policy should ensure that the outsourcing service provider's financial performance and essential changes in the service provider's organisation structure and ownership structure are appropriately monitored and assessed by the outsourcing institution's management so that any necessary corrective measures can be taken promptly.
5. The outsourcing institution should specify the internal units or individuals that are responsible for monitoring and managing each outsourcing arrangement.
6. The policy should consider the main phases that make up the life cycle of an institution's outsourcing arrangements:
  - a. the decision to outsource or change an existing outsourcing arrangement (the decision making phase);
  - b. due diligence checks on the outsourcing service provider;

- c. drafting a written outsourcing contract and service level agreement (the pre-contractual drafting phase);
- d. the implementation, monitoring, and management of an outsourcing arrangement (the contractual phase). This may include also the following-up of changes affecting the outsourcing service provider (e.g. major change in ownership, strategies, profitability of operations);
- e. dealing with the expected or unexpected termination of a contract and other service interruptions (the post-contractual phase). In particular, outsourcing institutions should plan and implement arrangements to maintain the continuity of their business in the event that the provision of services by an outsourcing service provider fails or deteriorates to an unacceptable degree, or the firm experiences other changes. This policy should include contingency planning and a clearly defined exit strategy.

#### **Guideline 7**

**An outsourcing institution should manage the risks associated with its outsourcing arrangements.**

1. Compliance with this article should include an on-going assessment by the outsourcing institution of the operational risks and the concentration risk associated with all its outsourcing arrangements. An outsourcing institution should inform its supervisory authority of any material development.

#### **Guideline 8**

**All outsourcing arrangements should be subject to a formal and comprehensive contract. The outsourcing contract should oblige the outsourcing service provider to protect confidential information.**

1. Any outsourcing arrangement should be based on a clear written contract.
2. An outsourcing institution should make sure that the written contract takes account of the following (bearing in mind other specific national rules and legislation):
  - a. The operational activity that is to be outsourced should be clearly defined.
  - b. The precise requirements concerning the performance of the service should be specified and documented, taking account of the objective of the outsourcing solution. The outsourcing service provider's ability to meet performance requirements in both quantitative and qualitative terms should be assessable in advance, including compliance with these Guidelines.

- c. The respective rights and obligations of the outsourcing institution and the outsourcing service provider should be precisely defined and specified. This should also serve to ensure compliance with laws and supervisory regulations and guidelines for the duration of the outsourcing arrangement.
  - d. In order to underpin an effective policy for managing and monitoring the outsourced activities, the contract should include a termination and exit management clause, where proportionate and if deemed necessary, which allows the activities being provided by the outsourcing service provider to be transferred to another outsourcing service provider or to be reincorporated into the outsourcing institution.
  - e. The contract should cover the protection of confidential information, banking secrecy and any other specific provisions relating to handling confidential information. Whenever information is subject to confidentiality rules at the level of the outsourcing institution at least the same level of confidentiality should be ensured by the service provider.
  - f. The contract should ensure that the outsourcing service provider's performance is continuously monitored and assessed so that any necessary corrective measures can be taken promptly.
  - g. The contract should include an obligation on the outsourcing service provider to allow the outsourcing institution's compliance and internal audit departments complete access to its data and its external auditors full and unrestricted rights of inspection and auditing of that data.
  - h. The contract should include an obligation on the outsourcing service provider to allow direct access by the outsourcing institution's supervisory authority to relevant data and its premises as required.
  - i. The contract should include an obligation on the outsourcing service provider to immediately inform the outsourcing institution, or the supervisory authority directly, of any material changes in circumstances which could have a material impact on the continuing provision of services. This may require obtaining consents from affected parties such as the parent company and relevant home supervisory authority.
  - j. The outsourcing contract shall contain provisions allowing the outsourcing institution to cancel the contract by contractual notice of dismissal or extraordinary notice of cancellation if so required by the supervisory authority.
3. When drafting the contract the outsourcing institution should bear in mind that the level of monitoring, assessment, inspection and auditing required by the contract should be proportionate to the risks involved and the size and complexity of the outsourced activity.

## Guideline 9

**In managing its relationship with an outsourcing service provider an outsourcing institution should ensure that a written agreement on the responsibilities of both parties and a quality description is put in place.**

1. A written agreement should normally contain a mixture of quantitative and qualitative performance targets, to enable an outsourcing institution to assess the adequacy of service provision.
2. An outsourcing institution should also consider the need to evaluate the performance of its outsourcing service provider using mechanisms such as service delivery reports, self-certification or independent review by the outsourcing institution's, or the outsourcing service provider's, internal and/or external auditors.
3. An outsourcing institution should be prepared to take remedial action if the outsourcing service provider's performance is inadequate.

## Guideline 10

**10.1 The outsourcing institution should take account of the risks associated with "chain" outsourcing.**

**10.2 The outsourcing institution should agree to chain outsourcing only if the sub-contractor will also fully comply with the obligations existing between the outsourcing institution and the outsourcing service provider, including obligations incurred in favour of the supervisory authority.**

**10.3 The outsourcing institution should take appropriate steps to address the risk of any weakness or failure in the provision of the sub-contracted activities having a significant effect on the outsourcing service provider's ability to meet its responsibilities under the outsourcing agreement.**

1. The sub-outsourcing of outsourced activities and functions to third parties (sub-contractors) should be treated by the outsourcing institution like a primary outsourcing measure. Compliance with these conditions should be ensured contractually, for example by a clause in the outsourcing contract requiring the prior consent of the outsourcing institution to the possibility and the modalities of sub-outsourcing.
2. The outsourcing institution should ensure that the outsourcing service provider agrees that the contractual terms agreed with the sub-contractor will always conform, or at least not be contradictory, to the provisions of the agreement with the outsourcing institution.

***Part 3: Guidelines on outsourcing addressed to supervisory authorities***

**Guideline 11**

**Supervisory authorities should require that the outsourcing institution has established supervisory authority access to relevant data held by the outsourcing service provider and, where provided for by the national law, the right for the supervisory authority to conduct on-site inspections at an outsourcing service provider's premises.**

1. Supervisory authorities should aim to be satisfied that outsourcing institutions ensure that their outsourcing contracts with outsourcing service providers grant the supervisory authority the rights to information and, where provided for by the national law, to inspection, admittance and access (including access to databases), as well as the right to give directions or instructions, which the supervisory authority needs to exercise its supervisory functions.
2. Supervisory authorities should encourage outsourcing institutions to ensure that information may also be made available to the supervisory authority by the outsourcing service provider's external auditor.
3. Supervisory authorities should aim to ensure that their powers to issue orders or instructions to the outsourcing institution can be reliably enforced, without being compromised by instructions issued to the outsourcing service provider' by other bodies, so as to ensure the orderly performance of the outsourced activities.
4. The supervisory authorities should aim to ensure that they can obtain detailed information about any outsourcing processes which might undermine the stability of the consolidated group whose overall supervision is, ultimately, their responsibility.
5. In the case of outsourcing to service providers abroad, the outsourcing institution should be responsible for ensuring that the supervisory authority can exercise its information gathering rights, including its right to demand documents and audits, and, compatibly with the overall legal framework its inspection rights.
6. The requirement to cancel the outsourcing contract (under Guideline 8.2(j)) should be properly justified by the supervisor on the basis of non-compliance with the provisions of these Guidelines, in particular of those with regard to the safeguarding of rights of supervision and enforcement.

7. The outsourcing institution may – prior to outsourcing – consider in consultation with the supervisory authority what alternative measures could adequately mitigate the risks involved.

#### **Guideline 12**

**Supervisory authorities should take account of concentration risk.**

Supervisory authorities should seek to identify any concentration risk on a sectoral level and seek to monitor these risks at a systemic level.



## VI. Guidelines on Reporting

### Guidelines for the Implementation of the Framework for Consolidated Financial Reporting (FINREP) 133

[http://www.c-ebs.org/documents/Publications/Consultation-papers/2005/CP06/CP06revAnnex1\\_tracked.aspx](http://www.c-ebs.org/documents/Publications/Consultation-papers/2005/CP06/CP06revAnnex1_tracked.aspx)

Link to the website on the implementation questions:  
<http://www.c-ebs.org/Publications/Q-As/Implementation-Questions.aspx>

#### GUIDELINES FOR THE IMPLEMENTATION OF THE FRAMEWORK FOR CONSOLIDATED FINANCIAL REPORTING (FINREP)

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<sup>133</sup> As to the history of the guidelines for the implementation of the framework for consolidated financial reporting the recently revised version of the document can be found on the CEBS website, at the following link: [http://www.c-ebs.org/documents/Publications/Standards---Guidelines/files-from-old-website/Final\\_CP06revAnnex2\\_.aspx](http://www.c-ebs.org/documents/Publications/Standards---Guidelines/files-from-old-website/Final_CP06revAnnex2_.aspx) The guidelines for the implementation of the framework for consolidated financial reporting (FINREP) were first published in December 2006 and revised in July 2007. CEBS has carried out a study to assess the level of convergence achieved by the introduction of the CEBS Guidelines on Reporting aiming to provide a first overview of the progress made in this area. The related report can be accessed here: <http://www.c-ebs.org/News--Communications/Archive/2007/CEBS-PUBLISHES-AN-ASSESSMENT-OF-CONVERGENCE-ON-SUP.aspx>

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## **CHAPTER I : GENERAL GUIDELINES**

The objective of this document is to give guidelines for the implementation of the consolidated financial reporting framework (FINREP). FINREP is based on international financial reporting standards (IAS/IFRS), but the present guidelines should not be seen as an interpretation of the standards. It is the responsibility of credit institutions to comply with the standards.

### **1. Accounting and measurement rules governing the financial reporting framework**

The financial reporting framework (FINREP) has been developed on the basis of the International Financial Reporting Standards (IAS/IFRS) that have been endorsed by the European Commission as of 31st December 2006.

### **2. Scope of application**

FINREP is designed for application by credit institutions when preparing their consolidated supervisory financial returns under IAS/IFRS as and when required by their national supervisory authority<sup>134</sup>. The Guidelines on FINREP are not mandatory. Each national supervisor remains free to apply the framework to supervised credit institutions within its jurisdiction. Some supervisors do not collect financial information by means of periodic prudential reports and do not plan to apply FINREP. However, once an authority decides to apply the framework it should, as a minimum, require the core information.

The scope of consolidation under FINREP may be defined by reference either to IAS/IFRS or the Capital Requirements Directive (CRD), as the national supervisory authority considers appropriate.

The purpose of the table 39 'Scope of consolidation' is to provide information on companies included at the reporting date and on changes (additions, removals) in the scope of consolidation scope that occurred during the period ending on the reporting date.

### **3. Structure of the Financial Reporting Framework**

IAS/IFRS do not prescribe the order or format in which financial information is to be presented. Hence they offer a certain number of presentational choices. FINREP represents a common standardised reporting framework with the objective to increase comparability of financial information produced by credit institutions for their respective national supervisory authorities. Standardisation and comparability made

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<sup>134</sup> National supervisory authorities may decide to apply FINREP for sub-consolidated or solo reporting purposes, taking into account local specificities.

it necessary to limit some presentational options available under the IASB Standards.<sup>135</sup>

FINREP is composed of a set of tables divided into two sections which contain quantitative financial information designated as 'core' and 'non-core' respectively. FINREP also includes financial information which under IAS/IFRS may be provided in the form of a note disclosure. The framework does not allow the possibility of providing certain information in notes, as this would reduce standardisation and the comparability of the required information.

National supervisory authorities may decide to require additional quantitative and qualitative financial information.

### **3.1. Core information**

Core information designates the minimum information required by credit institutions if and when their national supervisory authority requires to prepare consolidated prudential financial reporting under IAS/IFRS.

Core information comprises the following tables:

- 1. Consolidated Balance Sheet
  - 1.1 Assets
  - 1.2 Liabilities
  - 1.3 Equity
- 2. Consolidated Income Statement

### **3.2. Non-core information**

Non-core information is based on the core information. It provides additional details and contributes through standardisation of data items to more commonality of reporting among European supervisory authorities.

Within the pre-defined format of non-core information or within the core information, national authorities may require additional disaggregations on:

- the allocation of financial assets by class of economic sector (see the FINREP framework and Annex 1)
- the detail of equity instruments (see Chapter II, detailed guidance)

Reporting of non-core information is optional to supervisory authorities on a national level.

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<sup>135</sup> CEBS will develop an XBRL taxonomy for FINREP that will allow credit institutions to report the required data to prudential authorities (in a way that is in line with FINREP) all the while using a different presentation or layout in their own systems.

### **3.3. References**

FINREP contains references to the IAS/IFRS, to the CRD, to an ECB Regulation or to Common Practice (CP) as appropriate.

The references to IAS/IFRS requirements are not restricted to specific disclosure requirements. The references are also used to provide for a definition of the contents of the captions respectively to give guidance on the recognition, derecognition or measurement rules applicable to the data requested.

Where no reference is available under IAS/IFRS, reference is made to EU Directives (for links explained in Chapter I, section 5), to an ECB Regulation or to Common Practice (CP). CP is used throughout FINREP for different purposes, e.g. (i) adding data items needed for completing breakdowns, and (ii) adding data items that are deemed relevant for supervisory purposes and that in current practice are frequently reported by credit institutions or requested by supervisors.

### **3.4. Structure of the consolidated balance sheet**

Under IFRS financial instruments may be presented by product (product approach) or by category of financial instruments (portfolio approach). In FINREP preference has been given to a portfolio approach. With the exception of *Cash balances with central banks* and *Deposits from central banks*, financial instruments are presented by categories of financial assets and financial liabilities, in accordance with IAS 39.9 and IFRS 7.8 respectively.

In accordance with IAS 1.69, specific line items which are considered relevant for the understanding of a credit institution's financial position have been included on the face of the consolidated balance sheet.

### **3.5. Structure of the consolidated income statement**

FINREP consolidated income statement shows income and expenses from continuing operations separately from discontinued operations. Items of income or expense from continuing operations are presented by nature. Major captions are broken down into their component parts with reference to the balance sheet categories of financial instruments.

In accordance with disclosure requirements set out under IFRS 7.20 (a), gains (losses) on financial assets and liabilities are presented on a net basis on the face of the consolidated income statement. A disaggregation of the net gains (losses) into their component parts (i.e. breakdown by category or by type of instrument) is either required on the face of the consolidated income statement (as part of core information) or in the tables (as part of non-core information). From a prudential perspective, disaggregation of gains and losses is considered of importance for the assessment of the financial performance of supervised credit institutions.

In accordance with IFRS 5.33 (a), income (expenses) from discontinued operations are disclosed as a net single amount in one specific line item on the face of the consolidated income statement.

Specific line items which are considered relevant for the understanding of a credit institution's financial performance have been included in accordance with IAS 1.83 on the face of the consolidated income statement.

### **3.6. Additional tables**

Tables provide disaggregated information on main captions of the core information, in accordance with specific IAS/IFRS disclosure requirements or with reference to common practice. Furthermore, selected tables provide additional quantitative information such as information about a credit institution's exposure to credit risks arising from financial instruments, in accordance with IFRS 7 and with the CRD.

FINREP tables include a number of breakdowns, such as splitting of the financial instrument categories by product, details on provisions, on revaluation reserves and other valuation differences, on interest income and expenses, on derivatives, which cannot always be fully derived from IAS/IFRS. The breakdowns have been carefully designed in order to complement the general guidance on presentational issues contained in the Standards. In general, the breakdowns are common in the banking sector and relevant for supervisory purposes, in particular where breakdowns are included to link the data with items of the Common Framework for Reporting of the Solvency Ratio (COREP) when calculating prudential own funds under IAS/IFRS.

Except when otherwise stated, total amounts reported in the tables should be equal to the total amount of the corresponding caption of the consolidated balance sheet or income statement.

## **4. Accounting conventions**

### **4.1. Trade date versus settlement date**

Under certain circumstances IAS/IFRS allow to recognise or derecognise a financial asset either on the date that an entity commits itself to purchase or sell an asset (trade date) or on the date that an asset is delivered to or by an entity (settlement date). See IAS 39.38 and IAS 39 AG 53-56. This choice may differ according to the category of financial assets concerned. The method used is subject to the condition of consistent application.

The choice of the accounting date may result in timing differences in the recognition of purchases and sales in the income statement and the balance sheet (see IAS 39 IG D.2.1 and D.2.2 for illustrative examples).

FINREP does not prescribe the use of a certain method and consequently credit institutions may choose unless national supervisory authorities require either method for national harmonisation purposes. CEBS may

reconsider the issue should practice prove that the choice has a significant impact on the financial position or solvency.

#### **4.2. Accrued interest and interest rate margin**

FINREP allows the measurement and reporting of financial instruments using the clean price or the dirty price convention in the following way:

- in the balance sheet, unpaid accrued interest under both conventions is included in the (category of) financial instruments to which it relates;
- in the income statement, interest income and interest expenses from financial instruments held for trading and financial instruments designated at fair value through profit or loss may be reported either as part of interest income/expense ('clean pricing') or under net gains (losses) from these categories of instruments ('dirty pricing').

In consideration of these possibilities, the calculation of the interest rate margin may vary from one credit institution to another. Supervisory authorities may want to standardise the calculation of the interest rate margin at national level. In addition, authorities may permit or require credit institutions to report the amounts of accrued interest income and accrued interest expenses from all or selected categories of financial instruments separately by using a standardised template (see FINREP framework).

#### **5. Links to the Common Framework for Reporting of the Solvency Ratio (COREP)**

FINREP includes certain requirements to provide links to COREP and possibilities for the linking the data reported under both reporting frameworks. Examples of these are:

- (i) the breakdown of the revaluation reserves and other valuation differences for linking the data with the own funds calculation (COREP CA template);
- (ii) the use of the economic sector allocation classes as presented in Annex 1;
- (iii) the use of the product breakdown in table *30B Allowances movements for credit losses*, which is a combination of the IFRS 7 and the CRD Annex XII requirements.

#### **6. Reporting frequency**

The reference to IFRS is not applicable for the determination of reporting frequency. The reporting frequency is at national discretion of the supervisory authorities. Supervisory authorities may define different reporting frequencies for and within core and non-core information. This means that national supervisory authorities may require specific tables (of both core and non-core information) to be reported at a lower frequency than others.

## **CHAPTER II: DETAILED GUIDANCE**

### **1. Investments in subsidiaries accounted for using the equity method (tables 1.1, 2 and 13)**

Investments in subsidiaries shall not be accounted for using the equity method, but as stated in IAS 27 using the scope of consolidation prescribed in this standard. However, CEBS agreed to leave members the option to implement the guidelines using either the scope of consolidation prescribed in the standards or the one asked for by the CRD, which basically excludes subsidiaries which are insurance and non-financial companies. Therefore, when using the latter method, banks may need to apply the equity method to those investments in insurance and non-financial subsidiaries. This is the reason for including the term 'subsidiaries' in these items (investments accounted for using the equity method and the share of profit or loss of investments using the equity method).

### **2. Deposits from credit institutions (table 1.2 and tables 14, 15 and 16)**

In the consolidated balance sheet statement – liabilities (table 1.2) and related detailed tables 14, 15 and 16 reference is made to deposits from credit institutions.

In the context of financial liabilities, the term "credit institution" is used with reference to the legal definition of a credit institution, as defined by local legislation. Deposits from credit institutions cover all financing received by the reporting entity from a counterparty that is a credit institution (by virtue of a banking license or other local specificities) in the normal course of the banking business. Consequently, 'deposits other than from credit institutions' gather liabilities to all other counterparties such as other financial institutions, corporates or private customers.

### **3. Equity component of financial instruments (table 1.3)**

The Equity component of financial instruments is presented in the FINREP consolidated balance sheet – equity as part of "Other equity". In FINREP, all contractual obligations, including those arising from a derivative financial instrument, that will or may result in the future delivery of the issuer's own equity instruments in accordance with IAS 32.16 (a) and (b), IAS 32.AG 27 (a) as well as the equity component of compound financial instruments (i.e. non-derivative financial instruments) issued by the entity, in accordance with IAS 32.28, should be reported as an equity component of financial instruments.

### **4. Treasury shares (table 1.3)**

The FINREP consolidated balance sheet – equity (table 1.3) makes reference to treasury shares. The term treasury shares covers all financial instruments which have the characteristics of own equity instruments in

accordance with IAS 32.33 which have been reacquired by the issuing entity. Examples of equity instruments are contained in AG13 of IAS 32.

#### **5. Interest income and Interest expenses (table 2)**

In the FINREP consolidated income statement (table 2), interest income and interest expenses from financial instruments held for trading and financial instruments designated at fair value through profit or loss may be reported either as part of interest income/expense ('clean pricing') or under net gains (losses) from these categories of instruments ('dirty pricing').

#### **6. Impairment on equity instruments included in the Available-for-sale category but registered at cost (Table 2 and 30A)**

In both tables, the impairment losses arising from the application of the rules about impairment included in IAS 39.66 will be included in the item "Impairment on financial assets at cost (unquoted equity)".

#### **7. Dividend income (table 2)**

In the FINREP consolidated income statement (table 2), dividend income from financial assets held for trading and from financial assets designated at fair value through profit or loss may be reported either as part of dividend income (clean pricing) or under gains (losses) on financial assets and liabilities held for trading, net and/or gains (losses) on financial assets and liabilities designated at fair value through profit or loss, net (dirty pricing) respectively. National supervisory authorities may permit or require credit institutions to report the amounts of dividend income separately.

#### **8. Provisions (table 2)**

In the FINREP consolidated income statement (table 2), the aggregate amount of additions to and reversals of provisions is presented in a separate line item based on their function. However, in accordance with IAS 1.88, and to the extent practicable, entities can be allowed by their national supervisory authority to allocate these items of income and expense based on their nature.

#### **9. Derivatives (tables 3 and 8)**

Credit institutions are required to provide data on the carrying amount and on the gross notional amount of derivatives held for trading (table 3) and derivatives held for hedge accounting (table 8), broken down by type of underlying risk.

When the carrying amount of a derivative, such as an equity swap is influenced by more than one type of underlying risk, the instrument should be allocated to the most risk sensitive type of risk.

Derivatives included in compound or hybrid instruments (IAS 39.11, IAS 39 AG 27 and AG 29, IAS 32.28) which are separable from the host contract should be recorded separately from the host contract and, where

appropriate, presented in the balance sheet according to the nature of the derivative. However, in case the contract is designated as at fair value through profit or loss under the fair value option, the contract should be included as a whole in the category of financial instruments designated at fair value through profit or loss.

Derivatives that are not designated as effective hedging instrument should always be included in the held-for-trading category. This should even apply to derivatives that are linked to unquoted equity instruments whose fair value cannot be reliably measured.

With regard to the notional amount to report in these tables, the strike price of the option (multiplied by the number of underlying instruments) will be the amount to report.

### 10. Available-for-sale financial assets (table 5)

Table 5 introduces a product breakdown of available-for-sale (AFS) financial assets. Within this product breakdown, credit institutions are requested to indicate the fair value of impaired assets and of unimpaired assets respectively, and the cumulative amount of impairment losses recognised in profit or loss as at the reporting date.

The following examples serve for illustrative purposes for the possible treatment of a decline in the fair value of an AFS financial asset that is impaired.

*Illustrative example 1: Impaired AFS financial assets (according to IAS 39.67-68)*

|                           |    |     |                    |
|---------------------------|----|-----|--------------------|
| Acquisition cost (T-0)    |    | 100 |                    |
| Fair Value (T-1)          | 95 | }   | cumulative loss 30 |
| Impaired Fair Value (T-2) | 70 |     |                    |

- (1) Initial measurement of AFS
- (2) Fair value change unimpaired (loss through equity)
- (3) Fair value change due to impairment (loss through equity)
- (4) Impairment loss (cumulative loss from equity to income statement)

| AFS |     | Equity |    |    | P/L |     | Cash |         |
|-----|-----|--------|----|----|-----|-----|------|---------|
| (1) | 100 | (2)    | 5  | 5  | (4) | (4) | 25   |         |
|     | 5   | (3)    | 25 | 25 | (4) | (4) | 5    |         |
|     | 25  |        |    |    |     |     |      | 100 (1) |

*Illustrative example 2: Impaired AFS financial assets (according to IAS 39.67-68)*

|                           |     |     |                      |
|---------------------------|-----|-----|----------------------|
| Acquisition cost (T-0)    |     | 100 | } cumulative loss 30 |
| Fair Value (T-1)          | 105 |     |                      |
| Impaired Fair Value (T-2) | 70  |     |                      |

- (1) Initial measurement of AFS
- (2) Fair value change unimpaired (gain through equity)
- (3) Fair value change due to impairment (loss through equity)
- (4) Impairment loss (cumulative loss from equity to income statement)

| AFS |        | Equity |    |        | P/L |    | Cash |         |
|-----|--------|--------|----|--------|-----|----|------|---------|
| (1) | 100    | (3)    | 35 | 5 (2)  | (4) | 30 |      | 100 (1) |
| (2) | 5      |        |    | 30 (4) |     |    |      |         |
|     | 35 (3) |        |    |        |     |    |      |         |
|     |        |        |    |        |     |    |      |         |

**11. Loans and receivables and held-to-maturity investments (table 6)**

Table 6 allows assessing the overall quality of loans and receivables and held-to-maturity investment portfolios, broken down by type of product, through their disaggregation into unimpaired and impaired assets. In addition, credit institutions are requested to disclose the allowances for individually assessed financial assets separately from the allowances for collectively assessed financial assets.

According to the IASB standards, collective evaluation of impairment applies to financial assets that are not individually significant and to financial assets for which there is no objective evidence of individual impairment. This approach does not preclude an entity from performing an individual impairment evaluation of loans that are individually insignificant.

The collective impairment assessment process can be illustrated as follows:

| A. Significant loans (e.g. 100 loans) |        |                                                          | B. Insignificant loans           |  |
|---------------------------------------|--------|----------------------------------------------------------|----------------------------------|--|
|                                       |        | Individually significant loans                           | Individually insignificant loans |  |
| Impaired on individual basis          | Step 1 | Individual impairment evaluation (e.g. 7 impaired loans) | Collective impairment assessment |  |
|                                       |        |                                                          |                                  |  |
| Unimpaired on individual basis        | Step 2 | Collective impairment assessment (for e.g. 93 loans)     |                                  |  |

The amount of “Allowances for collectively assessed financial assets” to be disclosed in table 6, comprises the aggregate amount of collective impairment losses determined as a result of steps 1.B and 2.A as described above.

IFRS 7 does not require a split into individually assessed financial assets and collectively assessed financial assets. However, the insertion of this split in table 6 may be of particular interest to supervisors and is also important for alignment with COREP.

## 12. Information on Impairment and Past due assets (table 7)

In accordance with IFRS 7.37, table 7 requires an analysis of the age of the assets that are past due as at the reporting date but not impaired at that date. This information covers financial assets included in the categories available-for-sale, loans and receivables as well as held-to-maturity.

Assets qualify as past due when a counterparty has failed to make a payment when contractually due. Amounts of such assets should be indicated and broken down according to the number of past due days. The past due analysis should not include any impaired assets as IFRS 7.37 requires the carrying amount of the impaired assets to be disclosed separately from the past due assets.

## 13. Tangible and intangible Assets (tables 9,10 and 11).

The tables on Property, Plant and Equipment (table 9), Investment Property (table 10) and Goodwill and other Intangible Assets (table 11) are provided in a common harmonised format to meet the disclosure requirements of IAS 16, IAS 40 and IAS 38 respectively. In accordance with these standards, credit institutions have a choice of either applying the revaluation model or the cost model for measuring property, plant and equipment and intangible assets and the fair value model or the cost model for investment property. Depending on the model chosen for property, plant and equipment and for intangible assets, relevant tables are to be filled-in.

#### **14. Investments in associates, subsidiaries and joint ventures (table 12)**

Table 12 contains summarised financial information of associates, subsidiaries and joint ventures with the possibility of accounting for them using the equity or non equity methods. The level of detail provided in the tables is to be based on respective IAS/IFRS disclosure requirements.

Sub-table B is designed to provide financial information on subsidiaries which are not consolidated since they are outside the scope of consolidation. This is the case where credit institutions are required by their national supervisory authority to prepare consolidated financial statements with reference to the prudential scope of consolidation.

#### **15. Derecognition and financial liabilities associated with transferred financial assets (table 17)**

Table 17 discloses transferred financial assets for which part or all of the financial assets do not qualify for derecognition (see IAS 39.15-37). To provide a link with COREP, the table requires an indication on financial assets that may be derecognised for capital purposes.

#### **16. Realised gains and losses on financial assets and liabilities not measured at fair value through profit or loss, net (table 21)**

This breakdown shows all gains and losses on financial instruments not measured at fair value through the income statement that arise at derecognition.

#### **17. Repurchase agreements, reverse repurchase agreements and related agreements (table 33)**

Repurchase agreements (repos), reverse repurchase agreements (reverse repos) and related agreements are not presented separately on the face of the balance sheet. Table 33 has been designed to provide detail information on the agreements included in each balance sheet category.

Repos, reverse repos and related agreements can involve collaterals transferred that must be identified by the transferor and cash received or loaned out. Tables on repurchase agreements allow distinguishing these various types of situations.

Under sub-tables A and C, credit institutions are required to provide data on the carrying amount of repos and reverse repos and related agreements broken down by category of financial assets/liabilities and by the nature of the instrument that is subject to the transaction. Although this type of information may not be readily available in the credit institution's accounting system, it should nevertheless be available, e.g. in the front office systems, because financial instruments used as collateral in a repo should be accounted for separately from other financial instruments (IAS 39.37 (a)).

The row "Other" of table A may include transactions on financial instruments not included in the categories determined according to IAS 39.9 (e.g., instruments included in disposal groups of assets).

Table A

This table shows financial assets that have been transferred to a third party under a repurchase agreement or a related agreement and are still recognised in the credit institution's balance sheet.

Table B

This table details liabilities recorded by the credit institution in the balance sheet due to financing received under a repurchase agreement or a related agreement.

Table C

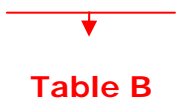

This table shows financial liabilities that are to be recognised by the credit institution in its balance sheet upon selling the collateral obtained under a reverse repurchase agreement or a related agreement.

Table D

This table presents the breakdown, per counterparty, of the financing given under a reverse repurchase agreement or a related agreement.

*Illustrative example*

Credit institution B (*transferee*) advances a certain amount to credit institution A (*transferor*), and receives collateral as guarantee.

| Transferor (A)                                                                                                                                                                                                      |            | Transferee (B) |                                                                                                           |                                                                                                                                                                                                                                |              |            |                                                                                                            |
|---------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|------------|----------------|-----------------------------------------------------------------------------------------------------------|--------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|--------------|------------|------------------------------------------------------------------------------------------------------------|
|                                                                                                                                                                                                                     |            |                |                                                                                                           |                                                                                                                                                                                                                                |              |            |                                                                                                            |
| If the transferee has no right to the collateral (i.e. all risks and rewards stay with the transferor):                                                                                                             |            |                |                                                                                                           |                                                                                                                                                                                                                                |              |            |                                                                                                            |
| <table border="1" style="width: 100%;"> <tr><td style="width: 50%; height: 100px; vertical-align: bottom;">AFS 100</td><td style="width: 50%; height: 100px; vertical-align: bottom;">Liab/B 100</td></tr> </table> | AFS 100    | Liab/B 100     |  <p><b>Table B</b></p> | <table border="1" style="width: 100%;"> <tr><td style="width: 50%; height: 100px; vertical-align: bottom;">Receiv/A 100</td><td style="width: 50%; height: 100px; vertical-align: bottom;">Cash &lt;100&gt;</td></tr> </table> | Receiv/A 100 | Cash <100> |  <p><b>Table D</b></p> |
| AFS 100                                                                                                                                                                                                             | Liab/B 100 |                |                                                                                                           |                                                                                                                                                                                                                                |              |            |                                                                                                            |
| Receiv/A 100                                                                                                                                                                                                        | Cash <100> |                |                                                                                                           |                                                                                                                                                                                                                                |              |            |                                                                                                            |
| If the transferee has the right to resell the collateral: (39.37a)                                                                                                                                                  |            |                |                                                                                                           |                                                                                                                                                                                                                                |              |            |                                                                                                            |
|                                                                                                                                                                                                                     |            |                |                                                                                                           |                                                                                                                                                                                                                                |              |            |                                                                                                            |
|                                                                                                                                                                                                                     |            |                |                                                                                                           |                                                                                                                                                                                                                                |              |            |                                                                                                            |

| Transferor (A)                                   |                | Transferee (B) |                |
|--------------------------------------------------|----------------|----------------|----------------|
| AFS 100                                          | Liab/B 100     | Receiv/A 100   | <b>Table D</b> |
| Loaned                                           | ↓              | Cash <100>     |                |
| Asset 100                                        | <b>Table B</b> |                |                |
| ↓                                                |                |                |                |
| <b>Table A</b>                                   |                |                |                |
| If the transferee sells the collateral: (39.37b) |                |                |                |
|                                                  |                | <b>Table D</b> |                |
| Loaned<br>100                                    | Liab/B         | Receiv/A 100   | Debt 110       |
| Asset 100                                        | ↓              | Cash <100>     | ↓              |
| ↓                                                | <b>Table B</b> | +110           | <b>Table C</b> |
| <b>Table A</b>                                   |                | 10             |                |

### 18. Use of tables 38 (Statement of changes in equity)

IAS 1.97 allows preparers of financial statements to disclose the information asked for by IAS 1.96-97 in two different ways:

- preparing a statement of recognised income and expense which includes the profit or loss for the period and each income and expense which is recorded in equity during the period, its allocation to equity holders of the parent and to minority interests and the effects of corrections of errors and changes in accounting policies (which is reflected in table 38B). In addition to this, disclosure must be made in the notes of the amount of transactions with equity holders in such capacity, the changes in retained earnings and the reconciliations between the opening and closing balances of each type of equity and reserve (table 38C);
- including all this information in a statement of changes in equity (table 38A)

On the other hand, IAS 19.93B prescribes that entities recognising the actuarial gains and losses in equity shall present a statement of recognised income and expense. Therefore:

- a) entities are free to choose to apply either table 38A or tables 38B and C;
- b) however, when recognising the actuarial gains and losses in equity, banks shall apply tables 38B and C.

## **ANNEX 1: CORRESPONDENCE TABLES ALIGNING ECONOMIC SECTOR ALLOCATION IN FINREP WITH EXPOSURE CLASSES IN CRD/COREP**

As it appears from the tables below there is not a complete matching between FINREP and COREP, due to for the availability of two different approaches under the CRD and the different purposes of risk based exposure classes and financial reporting. In particular, this is the case for the Standardised Approach. The tables may be helpful for credit institutions in order to prepare their IT systems and provide guidance about the classification of their instruments in the FINREP environment.

### **FINREP economic sector allocation classes**

The breakdown of economic sectors is composed of the following allocation classes (sometimes also called: counterparty breakdown):

- (1) Central governments;
- (2) Credit institutions;
- (3) Non credit institutions;
- (4) Corporates;
- (5) Retail.

This allocation is based on the exposure classes as defined in the CRD. The CRD uses different exposure class breakdowns for the Standardised Approach and the Internal Ratings Based Approach. COREP is based on these CRD-breakdowns for the different approaches. The choice made for the FINREP economic sector allocation classes is a compromise intended to allow credit institutions to organise their systems in a way that enables them to use both COREP approaches within the context of the financial reporting framework .

Annex 1 includes two tables to clarify how the exposure classes of the CRD could relate to the FINREP economic sector classes.

The subdivision "credit institutions" and "non credit institutions" correspond in principle to the exposure class "institutions" as used in the CRD. The separation is introduced to disclose separately the balances with credit institutions.

## Standardised Approach

| <i>SA exposure classes (CRD article 79.1)</i>             | <i>FINREP sector classes</i> | <i>economic allocation</i> | <i>Comments</i>                                                                                                                                                                    |
|-----------------------------------------------------------|------------------------------|----------------------------|------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| (a) Central governments and central banks                 | Central banks                |                            | In FINREP, all balances with central banks are separated from other categories of financial assets                                                                                 |
|                                                           | (1) governments              | Central                    |                                                                                                                                                                                    |
| (b) Regional governments and local authorities            | (1) governments              | Central                    |                                                                                                                                                                                    |
|                                                           | (3) institutions             | Non credit                 |                                                                                                                                                                                    |
| (c) Administrative bodies and non-commercial undertakings | (1) governments              | Central                    | Annex VI.3. For FINREP purposes, administrative bodies and non-commercial undertakings should not be allocated to credit institutions (even though this is possible under the CRD) |
|                                                           | (3) institutions             | Non credit                 |                                                                                                                                                                                    |
|                                                           | (4) Corporates               |                            |                                                                                                                                                                                    |
| (d) Multilateral development banks                        | Central banks                |                            |                                                                                                                                                                                    |
|                                                           | (1) governments              | Central                    |                                                                                                                                                                                    |
|                                                           | (3) Credit institutions      |                            |                                                                                                                                                                                    |
| (e) International organizations                           | Central banks                |                            | According to the Subsection 1                                                                                                                                                      |
|                                                           | (1) governments              | Central                    |                                                                                                                                                                                    |
|                                                           | (4) Corporates               |                            |                                                                                                                                                                                    |
| (f) Institutions                                          | (2) Credit institutions      |                            |                                                                                                                                                                                    |
|                                                           | (3) institutions             | Non credit                 |                                                                                                                                                                                    |
| (g) Corporates                                            | (4) Corporates               |                            |                                                                                                                                                                                    |

| <b>SA exposure classes<br/>(CRD article 79.1)</b> | <b>FINREP<br/>sector<br/>classes</b> | <b>economic<br/>allocation</b> | <b>Comments</b>                                                                                                                                                      |
|---------------------------------------------------|--------------------------------------|--------------------------------|----------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| (h) Retail                                        | (5) Retail                           |                                |                                                                                                                                                                      |
| (i) Secured on real estate property               | (1) governments                      | Central                        | These exposures should be included in each FINREP economic sector allocation class depending on the nature of the counterparty.                                      |
|                                                   | (2) Credit institutions              |                                |                                                                                                                                                                      |
|                                                   | (3) Non credit institutions          |                                |                                                                                                                                                                      |
|                                                   | (4) Corporates                       |                                |                                                                                                                                                                      |
|                                                   | (5) Retail                           |                                |                                                                                                                                                                      |
| (j) Past due items                                | (1) governments                      | Central                        | These exposures should be included in each FINREP economic sector allocation class depending on the nature of the counterparty.                                      |
|                                                   | (2) Credit institutions              |                                |                                                                                                                                                                      |
|                                                   | (3) Non credit institutions          |                                |                                                                                                                                                                      |
|                                                   | (4) Corporates                       |                                |                                                                                                                                                                      |
|                                                   | (5) Retail                           |                                |                                                                                                                                                                      |
| (k) High-risk categories                          | Equity                               |                                | In FINREP, equities are separated as products under different categories of financial assets<br><br>At least, it also includes non past due items receiving 150% RW. |
|                                                   | (1) governments                      | Central                        |                                                                                                                                                                      |
|                                                   | (2) Credit institutions              |                                |                                                                                                                                                                      |
|                                                   | (3) Non credit institutions          |                                |                                                                                                                                                                      |
|                                                   | (4) Corporates                       |                                |                                                                                                                                                                      |
|                                                   | (5) Retail                           |                                |                                                                                                                                                                      |
| (l) Covered bonds                                 | (1) governments                      | Central                        | These exposures should be included in each FINREP economic sector allocation class depending on the nature of the counterparty.                                      |
|                                                   | (2) Credit institutions              |                                |                                                                                                                                                                      |
|                                                   | (3) Non credit institutions          |                                |                                                                                                                                                                      |

| <b>SA exposure classes<br/>(CRD article 79.1)</b>    | <b>FINREP<br/>sector<br/>classes</b> | <b>economic<br/>allocation</b> | <b>Comments</b>                                                                                                                                        |
|------------------------------------------------------|--------------------------------------|--------------------------------|--------------------------------------------------------------------------------------------------------------------------------------------------------|
|                                                      | (4) Corporates                       |                                |                                                                                                                                                        |
| (m) Securitisation positions                         | (1) governments                      | Central                        | Depending on the underlying risk of the securitisation.                                                                                                |
|                                                      | (2) Credit institutions              |                                |                                                                                                                                                        |
|                                                      | (3) Non credit institutions          |                                |                                                                                                                                                        |
|                                                      | (4) Corporates                       |                                |                                                                                                                                                        |
|                                                      | (5) Retail                           |                                |                                                                                                                                                        |
| (n) Short-term claims on institutions and corporates | (2) Credit institutions              |                                |                                                                                                                                                        |
|                                                      | (3) Non credit institutions          |                                |                                                                                                                                                        |
|                                                      | (4) Corporates                       |                                |                                                                                                                                                        |
| (o) Collective investment undertakings               | Equity                               |                                | Depending on whether CIU has a residual interest in the assets and income. If look through is allowed, the underlying exposures are the relevant ones. |
|                                                      | (1) governments                      | Central                        |                                                                                                                                                        |
|                                                      | (2) Credit institutions              |                                |                                                                                                                                                        |
|                                                      | (3) Non credit institutions          |                                |                                                                                                                                                        |
|                                                      | (4) Corporates                       |                                |                                                                                                                                                        |
|                                                      | (5) Retail                           |                                |                                                                                                                                                        |
| (p) Other items                                      | Equity                               |                                | In FINREP, other items may be included under different asset categories                                                                                |
|                                                      | Other items                          |                                |                                                                                                                                                        |

## Internal Ratings Based Approach

| <i>IRBA exposure classes<br/>(CRD article 86.1)</i> | <i>FINREP<br/>sector<br/>classes</i> | <i>economic<br/>allocation</i> | <i>Comments</i>                                                                                    |
|-----------------------------------------------------|--------------------------------------|--------------------------------|----------------------------------------------------------------------------------------------------|
| (a) Central governments and central banks           | Central banks                        |                                | In FINREP, all balances with central banks are separated from other categories of financial assets |
|                                                     | (1) Central governments              |                                |                                                                                                    |
| (b) Institutions                                    | (2) Credit institutions              |                                | In order to disclose separately the balances with credit institutions                              |
|                                                     | (3) Non credit institutions          |                                |                                                                                                    |
| (c) Corporates                                      | (4) Corporate                        |                                |                                                                                                    |
| (d) Retail                                          | (5) Retail                           |                                |                                                                                                    |
| (e) Equity                                          | Equity                               |                                | In FINREP, equities are separated as products under different categories of financial assets       |
| (f) Securitisation positions                        | (1) Central governments              |                                | Depending on the underlying risk of the securitisation positions.                                  |
|                                                     | (2) Credit institutions              |                                |                                                                                                    |
|                                                     | (3) Non credit institutions          |                                |                                                                                                    |
|                                                     | (4) Corporates                       |                                |                                                                                                    |
|                                                     | (5) Retail                           |                                |                                                                                                    |
| (g) Other non credit obligations                    | Other items                          |                                | In FINREP, other items may be included under different asset categories.                           |

## Guidelines on Common Reporting (COREP)

[http://www.c-ebs.org/documents/Publications/Standards---Guidelines/files-from-old-website/Copy-of-Documentation\\_of\\_the\\_changes\\_GL04.aspx](http://www.c-ebs.org/documents/Publications/Standards---Guidelines/files-from-old-website/Copy-of-Documentation_of_the_changes_GL04.aspx)

[http://www.c-ebs.org/documents/Publications/Standards---Guidelines/files-from-old-website/GL04\\_CR.aspx](http://www.c-ebs.org/documents/Publications/Standards---Guidelines/files-from-old-website/GL04_CR.aspx)

[http://www.c-ebs.org/documents/Publications/Standards---Guidelines/files-from-old-website/GL04\\_MKR.aspx](http://www.c-ebs.org/documents/Publications/Standards---Guidelines/files-from-old-website/GL04_MKR.aspx)

[http://www.c-ebs.org/documents/Publications/Standards---Guidelines/files-from-old-website/GL04\\_OR.aspx](http://www.c-ebs.org/documents/Publications/Standards---Guidelines/files-from-old-website/GL04_OR.aspx)

[http://www.c-ebs.org/documents/Publications/Standards---Guidelines/files-from-old-website/GL04\\_CA.aspx](http://www.c-ebs.org/documents/Publications/Standards---Guidelines/files-from-old-website/GL04_CA.aspx)

|                                                                                                                                                                                                                                |
|--------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| <p><b>Link to the website on the implementation questions:</b><br/><a href="http://www.c-ebs.org/Publications/Q-As/Implementation-Questions.aspx">http://www.c-ebs.org/Publications/Q-As/Implementation-Questions.aspx</a></p> |
|--------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|

### EXPLANATORY NOTES TO THE TEMPLATES<sup>136</sup>

These explanatory notes present a very brief summary of the contents of each template.

As a result of the application of the principles of flexibility and consistency, a high degree of standardization has been achieved, providing the framework with important commonalities that streamline the number of the templates required to cover the full range of methods and approaches available in the CRD.

#### 1 General comments

The convention on signs used in the templates is made explicit at the bottom of the CA template: any amount that increases the own funds or the capital requirements will be reported as a positive figure. On the contrary, any amount that reduces the total own funds or the capital requirements will be reported as a negative figure. Where there is a

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<sup>136</sup> As to the history on the guidelines on common reporting, the consultation versions and the feedback tables of the explanatory notes along with the excel tables have been published on the CEBS website: [http://www.c-ebs.org/documents/Publications/Standards---Guidelines/files-from-old-website/GL04\\_notes.aspx](http://www.c-ebs.org/documents/Publications/Standards---Guidelines/files-from-old-website/GL04_notes.aspx)

negative sign ( ) preceding the label of an item, no positive figure is expected to be reported for that item. The relations among the items which are expressed by formulas in the templates already take into account the abovementioned convention on signs and are only valid if all the items referred to in the formula are reported.<sup>137</sup>

Detailed information elements in the templates corresponding to layer two are indicated by grey shaded in the corresponding labels by rows and columns. According to the national implementation of COREP, the templates will be introduced by general information on the reporting institution (such as name, code, etc.), on the level of reporting (consolidated, sub-consolidated or solo basis), and on the reporting timeframe, among others.

## **2 CA – Solvency Ratio Overview**

This is a summary template which mainly contains information about Pillar 1 numerator (own funds) and denominator (capital requirements). The template is designed to apply to all banks, irrespective of the accounting standards followed, although some items in the numerator are specific for banks applying IAS type valuation rules. Generally, the information in the denominator is linked to the final results reported in the correspondent templates for capital requirement.

## **3 Group Solvency Details**

This template is designed to gather information on credit and other regulated financial institutions and sub-consolidated subgroups which, being within the scope of application of the consolidation, are effectively subject to particular solvency requirements on individual or sub-consolidated basis.

This template provides for each entity or subgroup within the scope of the reporting, the capital requirements for each risk category, the own funds for solvency purposes and the resulting surplus or deficit of own funds.

2

In the case of proportional consolidation of participations, the figures related to capital requirements and own funds will reflect the respective proportional amounts.

## **4 Credit Risk Templates**

### **4.1 CR SA – Credit and counterparty credit risks and free deliveries:**

#### **Standardised Approach to Capital Requirements**

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<sup>137</sup> Please note that a Consultation Paper on Standardization on Remittance Dates and Reporting Frequencies for Supervisory Reporting had been published in December 2007, under the following link: <http://www.c-eps.org/News--Communications/Archive/2007/CEBS-APPROVES-A-PROPOSAL-FOR-STANDARDIZATION-OF-RE.aspx>.

This template provides detailed information on the distribution of the exposure values according to the different risk weights or by exposure types, therefore providing the necessary information for assessing the capital requirement for credit risk according to the standardized approach. This information may be requested for the total exposure classes or individually for each of the exposure classes as defined for the standardized or for the internal rating based approaches.

#### **4.2 CR IRB – Credit and counterparty credit risks and free deliveries:**

##### **Internal Rating Based Approach to Capital Requirements**

This template, applicable to IRB institutions, whether or not they use their own estimates of LGD and/or credit conversion factors, requests aggregated information on the input parameters that are used for calculating the risk weighted exposure amounts (exposure values, LGD, maturity,...) and on the amount and type of credit risk mitigation techniques used for mitigating the risks.

This information is available at the exposure type level, but also at the obligor grade level, thus providing an insight on the internal rating system of the banks.

This template also provides specific lines, with a more limited number of columns available, to report information by risk weight for exposures under the specialized lending slotting criteria approach, for exposures secured by real estate that benefit from an alternative treatment, as well as for free deliveries and dilution risk.

#### **4.3 CR EQU IRB – Credit Risk: Equity Internal Rating Based**

##### **Approaches to Capital Requirements**

This template provides relevant information on the capital requirements for equity exposures under all three existing approaches: the PD/LGD method, the Simple Risk Weight approach and the Internal Models approach.

The structure is very similar to that of the CR IRB template.

#### **4.4 CR SEC SA – Credit Risk: Securitisation – Standardised Approach to Capital Requirements**

The information in this template could be requested for all securitization types or separately for the traditional and the synthetic securitisations in which the reporting institution holds a securitisation position treated under the Standardised Approach.

3

The information to be reported is contingent on the role of the institution as for the securitisation. As such, specific reporting items are applicable for investors, originators and sponsors.

#### **4.5 CR SEC IRB Credit Risk – Securitisations – Internal Rating Based approach to Capital Requirements.**

The template follows the same structure of template CR SEC SA, but the columns have been adapted in order to accommodate to the methodology applicable under the IRB approach for securitisation positions.

#### **4.6 CR SEC Details – Credit Risk: Detailed information on securitisations by originators and sponsors**

This template gathers information on dealbydeal basis (versus the aggregate information reported in CR SEC SA and CR SEC IRB templates) on the securitisations originated or sponsored by the reporting institution. The main features of each securitisation, such as the nature of the underlying pool and the capital requirements on an individual basis are requested.

#### **4.7 CR TB SETT – Settlement/Delivery Risk in the Trading Book**

This template requests information on the unsettled transactions of the trading book and their related capital requirements for settlement risk.

### **5 MARKET RISK TEMPLATES**

#### **5.1 MKR SA TDI – Market Risk: Standardised Approach for Position Risks in Traded Debt Instruments**

This template captures the positions and the related capital requirements for position risks on traded debt instruments under the standardized approach. The different risks and methods available under the Directive 2006/49/EC are considered by rows. This structure is similar to that used in the other MKR SA templates below.

All the information could be requested for all currencies altogether or broken down by individual currencies.

#### **5.2 MKR SA EQU – Market Risk: Standardised Approach for Position Risk in Equities**

This template, with a similar structure to that of the other MKR SA templates, request information on the positions and the corresponding capital requirements for position risk in equities held in the trading book and treated under the standardised approach. All the information could be requested for all national markets altogether or broken down by individual national markets

4

#### **5.3 MKR SA FX – Market Risk: Standardised Approaches for Foreign Exchange Risk**

This template, with a similar structure to that of the other MKR SA templates, request information on the positions in nonreporting currencies and the corresponding capital requirements for foreign exchange and treated under the standardised approach.

#### **5.4 MKR SA COM – Market Risk: Standardised Approaches for Commodities**

This template, with a similar structure to that of the other MKR SA templates, request information on the positions in commodities and the corresponding capital requirements treated under the standardized approach. All the information could be requested for all commodities altogether or broken down by groupings of commodities.

#### **5.5 MKR IM – Market Risk Internal Model**

This template provides a breakdown of the VaR figures according to the different market risks (Debt, equity, FX, commodities). Other information relevant for the calculation of the capital requirements is also requested (specific risk surcharge, number of over-shootings, etc.)

#### **5.6 MKR IM Daily – Market Risk Internal Model Details**

This template requests for each internal model in place in the bank detailed information on the VaR figures, the profit & loss account and the back-testing on a daily basis. This daily information will be reported together to the supervisor according to the frequency of reporting decided in the national implementation of the framework.

### **6 OPERATIONAL RISK TEMPLATES**

#### **6.1 OPR – Operational Risk**

This template provides information on the capital requirements for Operational Risk under the Basic Indicator Approach (BIA), the Standardised Approach (STA), the Alternative Standardised Approach (ASA) and the Advanced Measurement Approaches (AMA).

For the AMA, information on the use of an allocation mechanism and the capital alleviation because of insurance and other risk transfer mechanisms is also requested.

#### **6.2 OPR Details – Operational Risk: Gross Losses by Business Lines and Event Types in the last year**

This template summarises the information (number of events, total loss amount and maximum single loss) on the gross losses suffered by the bank in the last year according to event types and/or business lines.



# APPENDICES

## Appendix 1

### Internal Governance Compilation

#### IG-Compilation

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## 1. Corporate Structure and Organisation

[SRP, IG 1]

**Institutions should have a corporate structure that is transparent and organised in a way that promotes and demonstrates the effective and prudent management of the institution both on a solo basis and at group level.**

The structure of an institution (and, where applicable, the structures and management lines of institutions within a group) should be clear and transparent both to the institution's own staff and to the relevant supervisory authorities. This is essential for supervisory oversight and for ensuring the effective and prudent management of the institution. Where appropriate, the supervisory authority may assess the legal organisation and the position of an institution within a group on a case-by-case basis.

[SRP, IG 2]

**The reporting lines and the allocation of responsibilities and authority within an institution should be clear, precise, well-defined, transparent, coherent, and enforced**

a. There should be clear, precise and well-defined reporting lines and a clear and precise allocation of responsibilities and authority within an institution. Opaque or 'shadow' structures within an institution damage the ability of the management body (both supervisory and management functions) to conduct business in a prudent fashion.

b. The management body (both supervisory and management functions) should set and enforce clear lines of responsibility and authority within the institution. It is important that staff understand and adhere to policies and procedures concerning their authority and responsibilities. Staff receiving the information must be given adequate powers and authority to act.

c. Internal reporting has a dual function: (i) it is used by the supervisory function as a tool for its oversight of the management function, and by the management function as a tool for its oversight of the entire institution; and (ii) staff use the information they receive from internal reports to carry out the responsibilities they have been given.

d. In cases where the business reporting lines do not match the legal structure of the institution or the group (e.g. operational structures where there is no coincidence between business areas and legal units), the management body (both supervisory and management functions) should ensure that areas of responsibility and authority are sufficiently clear and transparent. Reporting lines that deviate from the institution's legal structure could result from a matrix organisation, a functional organisation, or a geographically widespread organisation.

[SRP, IG 3]

**Institutions should ensure that the risk management function is organised in a way that facilitates the implementation of risk policies and the management of the institution's risks.**

a. The risk management function should be a central organisational feature of an institution. It should be structured in a way that permits it to achieve its objectives of implementing risk policies and managing risk within the institution. Large, complex and sophisticated institutions could consider establishing risk management functions to cover each material business line.

b. Risk management includes ongoing identification, measurement and assessment of all material risks that could adversely affect the achievement of the institution's goals. The procedures for risk monitoring and assessment need to be updated regularly. The management body (both supervisory and management functions) should set the risk strategy, the risk policy, and accordingly the risk-bearing capacity of the institution.

## **2. Management Body**

### ***2.1. General***

[SRP, IG 4]

**The responsibilities of the management body should be clearly defined in a written document. They should include setting the institution's business objectives, risk strategies and risk profile, and adopting the policies needed to achieve these objectives.**

a. These issues are the basis for the sound and prudent conduct of business, and should be decided at the level of the management body (both supervisory and management functions).

b. The management body (management function) is responsible for the implementation of the strategies and policies set by the management body (both supervisory and management functions). Written guidelines, manuals and other means that are deemed necessary should be used to facilitate the accurate implementation of the institution's overall objectives.

c. Documentation should include the essential duties and working procedures of the management body (both supervisory and management functions). These documents, along with the minutes of the meetings of the management body, (both supervisory and management functions) should help the supervisor to evaluate the operation of the management body (both supervisory and management functions).

d. In the case of subsidiaries, the responsibilities of the management body (both supervisory and management functions) should acknowledge the business objectives, risk profile and policies defined by the management body of the parent institution. It should also be clearly stated in written documentation that the management body (both supervisory and management functions) in the subsidiary is responsible for the appropriate implementation of the strategies and policies set by the parent institution (including any input from minority interests where the subsidiary is not wholly owned) within the subsidiary consistent with their own local obligations.

[SRP, IG 5]

**The management body should ensure that strategies and policies are communicated to all relevant staff throughout the organisation.**

The management body (management function) should inform and update the staff concerning the institution's strategies and policies, at least to the level needed to carry out their particular duties. This may be done through written guidelines, manuals or other means. It is also important that the staff understand and adhere to policies and procedures pertaining to their duties and responsibilities.

[SRP, IG 6]

**The management body should systematically and regularly review the strategies and policies for managing the risks of the institution.**

a. Every institution should have effective processes for identifying, managing, monitoring and reporting the risks that it is exposed to. The management body (both supervisory and management functions) should ensure that the relevant strategies and policies are amended when necessary to reflect changing internal and external factors. This is particularly true for the macroeconomic environment in which the institution operates and the position in the business cycle.

b. Committees within the management body (supervisory function) may be set up to address risk management and audit if this facilitates the development and maintenance of good governance practices, as outlined above.

[SRP, IG 7]

**The management body should develop and maintain strong internal control systems.**

a. Strong internal control systems are essential to the ICAAP. The management body (both supervisory and management functions) is responsible for developing and maintaining systems to ensure effective and efficient operations, adequate control of risks, prudent conduct of business, reliability of financial and non-financial information reported or disclosed both internally and externally, and compliance with laws, regulations and the institution's internal policies and procedures.

b. There are several instruments at the disposal of the management body (both supervisory and management functions) for maintaining a sufficiently high standard of internal control. These include the risk control function, the compliance function, and the internal audit function, all of which are described in the section on 'Internal Control' below.

[SRP, IG 8]

**The management body should ensure that internal control systems provide for adequate segregation of duties, in order to prevent conflicts of interest.**

In developing the internal control system, the management body (both supervisory and management functions), should ensure that there is a clear, transparent and documented decision-making process and a clear allocation of responsibilities and authority to ensure compliance with internal decisions and procedures. The internal control mechanisms should be adequate in relation to the business performed by the institution, and should constitute sound administrative and accounting procedures.

[SRP, IG 9]

**The management body should set effective strategies and policies to maintain, on an on-going basis, amounts, types and distribution of both internal capital and own funds adequate to cover the risks of the institution. (See ICAAP section for further details.)**

a. The management body (both supervisory and the management functions) should ensure that the institution's strategies and policies regarding both internal capital and own funds are both comprehensive and proportionate. Documentation should specify what types of own funds may be used (primary and supplementary capital). Furthermore, the distribution of own funds within a group must comply with legal requirements concerning the allocation of capital to subsidiaries.

b. For internal capital, the institution is free to use a different definition of capital from that used for regulatory purposes.

[SRP, IG 10]

**The management body should monitor and periodically assess the effectiveness of the institution's internal governance structure.**

a. At least once a year, the management body (both the supervisory and the management functions) should review and, if necessary, amend its policies for the internal governance structure of the institution. This frequency applies only to the internal governance issues covered by these guidelines. It does not transcend any legal obligations or recommendations concerning governance issues on the national level.

b. A review of the internal governance structure itself should also be performed annually. This review should focus on any changes in internal and external factors affecting the institution.

[SRP, IG 11]

**The management body should be active and independent, and should be able to explain its decisions to the supervisory authority and other interested parties.**

a. Notwithstanding their obligations towards other stakeholders as required under national law, the members of the management body (both supervisory and management functions) should be free to take decisions in the best interest of the institution. Their decisions should be clearly based on the information received and should take into account all relevant factors.

b. The members of the management body (both supervisory and management functions) should have the necessary expertise to carry out their duties, and should be able to make their own judgments and decisions.

c. While it is acknowledged that the management body (both supervisory and management functions) of a subsidiary is also expected to observe and implement the business objectives, risk profile and policies defined by the management body (both supervisory and management functions) of the parent institution, this has to be consistent with their own local obligations (including any in relation to minority interests where the subsidiary is not wholly owned).

[SRP, IG 12]

**The management body should have policies for selecting, compensating, monitoring and planning the succession of key executives.**

- a. One of the primary tasks of the management body (both supervisory and management functions) is to ensure that the institution has, and will continue to have, qualified and experienced key executives.
- b. The compensation schemes of the management body (both supervisory and management functions) should not be structured in a way that encourages unhealthy risk-taking or maximisation of short term profits.

[SRP, IG 13]

**The management body should promote high ethical and professional standards and an internal control culture.**

Implementing such standards throughout the institution should help reduce the risks to which it is exposed. For example, when the reputation of an institution is called into question, the loss of trust can be difficult to rebuild and can have repercussions throughout the market. In particular, operational risk will be reduced if these standards are given high priority. The management body (both supervisory and management functions) should therefore have clear policies for how these standards should be met, and they should perform a continuing review of their implementation.

## ***2.2. Management Body, Model Validation (IRB)***

### **2.2.1. Introduction**

[MV 411]

Annex VII, Part 4, Paragraphs 123 to 130 of the [Directive 2006/48/EC](#) set out minimum requirements regarding corporate governance and oversight, including a brief description of the roles of the management body and senior management. This section of the guidelines elaborates further on those minimum requirements.

[MV 412]

Paragraphs 362 to 364 of these Guidelines<sup>138</sup> provide an example of the general approach applied in this section. The aim is not to lay down a 'one-size-fits-all' approach to assessing an institution's organizational structure, internal governance, and internal control systems. Supervisors should tailor their assessment to the characteristics of respective

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<sup>138</sup> This is referring to the guidelines on validation.

institutions, taking into account their size and the complexity and nature of their business ('proportionality principle'). This could include a 'comply or explain' approach, in which an institution that has come to a different solution from the one set out by the supervisors has the opportunity to explain why it has chosen that solution and to convince the supervisors that it is at least as good as the solution suggested by the supervisors .

[MV 413]

Annex VII, Part 4, Paragraphs 123 to 126 of the [Directive 2006/48/EC](#) place requirements on the 'management body' and 'senior management' for understanding and approving rating systems. 'Management body' is defined in Article 11 of the Directive 2006/48/EC, and should be understood to embrace different structures, such as unitary and dual board structures. In keeping with CEBS Guidelines on Application of the Supervisory Review Process under Pillar 2, the use of these terms does not advocate any particular board structure. The management body represents the top management level of an institution, and senior management (which is not defined in the CRD) should be understood to represent the level of management below the management body.

[MV 414]

According to the CEBS Guidelines on the Supervisory Review Process, there are two key functions that must be fulfilled in any institution: supervision and management. Most Member States use one of two corporate governance structures: a unitary or a dual board structure. In a unitary board structure, one body (e.g. the 'board of directors') performs both the supervisory and management functions. In a dual board structure, the two functions are performed by different bodies. When CPO3rev identifies a function of the management body, it specifies whether the reference is to the supervisory function, the management function, or both.

[MV 415]

For the purpose of the present guidelines, it is not appropriate for CEBS to seek to define the responsibilities of the supervisory and management functions of the management body, because of the high degree of granularity in the CRD with regard to the IRB (and AMA – see section 4.3.5.) approaches, and the different traditions and legal frameworks. Therefore, it is up to each national authority to define which function of the management body is responsible for the tasks and responsibilities listed in the internal governance sections below, and which internal body of the institution represents the supervisory and which the management function.

## 2.2.2. Role of management body and senior management

[MV 421]

Sound internal governance requires that the decision making process be clearly stated within each institution, in terms of hierarchy and level of responsibility. In order to improve understanding of the rating system among the members of the management body, and to improve efficiency, the management body may, where appropriate, establish specific Risk Committees and delegate certain aspects of this framework to these committees or to senior management. Senior management itself may also delegate certain tasks. However, such delegations do neither relieve the management body and senior management from their obligation to have a general awareness of the IRB framework used by their institution, nor do they relieve the management body from its ultimate responsibility for the IRB framework and senior management from its responsibility for developing and implementing it.

[MV 422]

In accordance with Annex VII, Part 4, Paragraph 123 of the [Directive 2006/48/EC](#), all material aspects of the rating and estimation processes shall be approved by the institution's management body (or a designated committee thereof) and senior management. These parties shall possess a general understanding of the institution's rating systems and detailed comprehension of its associated management reports. The material aspects of the rating and estimation processes include among others:

- Risk management strategies and policies regarding the internal rating system (including all material aspects of the rating assignment and risk parameter estimation processes);
- The organisational structure of the control functions;
- Specifying acceptable risk (using IRB results to define the credit risk profile of the institution).

[MV 423]

Both the management body and senior management are responsible for making formal decisions on the implementation of the IRB approach. This includes the overall approval of the project, the specification of goals, and the appointment of the organisational structures responsible for implementation. A schedule of the necessary steps should be provided with the project approval. Both functions are ultimately responsible for sound governance of the IRB framework, and the further governance described below should flow from them.

[MV 424]

The management body has to exercise effective oversight. Therefore, as stated in Paragraph 124 of Annex VII, Part IV of the [Directive 2006/48/EC](#), senior management shall notify the management body, or a designated committee thereof, of material changes or exceptions from established policies that will materially impact the operations of the institution's rating systems. The management body should be involved, on an ongoing basis, in the oversight of the control procedures of Internal Audit.

[MV 425]

Senior management should ensure, on an ongoing basis, that the control mechanisms and measurement systems adopted by the credit risk control unit are adequate and that the overall IRB system remains effective over time. Senior management shall have a good understanding of the rating systems designs and operations. Furthermore, it should have a good understanding of credit policies, underwriting standards, lending practices, and collection and recovery practices, and should understand how these factors affect the estimation of relevant risk parameters. It should ensure that the following tasks are being addressed:

- Ensuring the soundness of risk-taking processes, even in a rapidly changing environment;
- Determining how internal ratings are used in the risk-taking processes;
- Identifying and assessing the main risk drivers, based on the information provided by the Credit Risk Control Unit;
- Defining the tasks of the risk control unit and evaluating the adequacy of its professional skills;
- Monitoring and managing all sources of potential conflicts of interest;
- Establishing effective communication channels in order to ensure that all staff are aware of relevant policies and procedures;
- Defining the minimum content of reporting to the management body or to bodies to which it has delegated responsibilities (e.g., the Risk Committee), and
- Examining reports from Internal Audit or another comparable independent audit unit.

[MV 426]

Senior management should also check, on a regular basis, that the control procedures and measurement systems adopted by the credit risk control unit and Internal Audit (or another comparable independent audit unit) are adequate and that the overall IRB system remains effective over time.

### **2.3. Management Body, Model Validation (AMA)**

#### **Introduction**

[MV 598]

Operational risk management differs from credit risk management, reflecting fundamental conceptual differences between operational risk and credit risk.

[MV 599]

Operational risk is inherent in every activity performed by an institution and in every part of its organisation, while credit risk is localised in portfolios. Credit risk is actively taken, in order to generate income, while operational risk is inherent in every activity performed by an institution. The amount of credit risk that an institution wants to take on can be defined and controlled using a limit system, while it is difficult to set limits for operational risk (although it can be mitigated by insurance and/or internal controls).

[MV 600]

Article 105(1) and (2) of the Directive 2006/48/EC provides that permission to calculate operational risk capital requirement using the AMA can be given only if the competent authority is satisfied that the institution meets the qualifying criteria in Annex X, Part 3 of the Directive 2006/48/EC.

[MV 601]

In particular, with regard to internal governance matters, the following elements have to be taken into account:

- **Reporting:** There should be a regular reporting on operational risk exposures and loss experience. The institution shall have procedures for taking appropriate corrective action. (Annex X, Part 3, Paragraph 4 of the [Directive 2006/48/EC](#)).

- **Operational risk management function:** The institution should have an independent risk management function for operational risk. (Annex X, Part 3, Paragraph 3).
- **Internal Audit:** The operational risk management processes and measurement systems shall be subject to regular reviews performed by internal and/or external auditors (Annex X, Part 3, Paragraph 6).

### **Hierarchy of responsibility, management body and senior management**

[MV 602]

Sound internal governance requires that the decision-making process be clearly stated within each institution, in terms of hierarchy and level of responsibility. In order to improve understanding of the operational risk measurement system among the members of the management body, and to improve efficiency, the management body may, where appropriate, establish specific Risk Committees and delegate certain aspects of this framework to these committees or to senior management. Senior management itself may also delegate certain tasks. However, such delegations do neither relieve the management body and senior management from their obligation to have a general awareness of the AMA framework used by their institution, nor do they relieve the management body from its ultimate responsibility for the AMA framework and the senior management from its responsibility for developing and implementing it.

[MV 603]

Both the management body and senior management should be responsible for approving all material aspects of the overall operational risk framework. They should have a general understanding of the institution's operational risk measurement systems and detailed comprehension of its associated management reports submitted to them and how operational risk affects the institution. The material aspects of the overall operational risk framework encompass:

- Activities aimed at identifying, assessing and/or measuring, monitoring, controlling, and mitigating operational risk
- Proactive risk management strategies and policies;
- The organisational structure of the control functions; and
- Specifying levels of acceptable risk.

[MV 604]

Both the management body and senior management are responsible for making formal decisions on the implementation of the AMA approach. This includes the overall approval of the project, the specification of goals, and the appointment of the organisational structures responsible for implementation. A time schedule of the necessary steps and an estimation of related costs and benefits should be provided with the project approval.

[MV 605]

The management body has to exercise effective oversight. Senior management should therefore notify the management body, or a designated committee thereof, of material changes or exceptions from established policies that will materially impact the institution's operational risk measurement systems and management processes.

[MV 606]

Both the management body and senior management should be involved, on an ongoing basis, in the oversight of the control procedures and measurement systems adopted by the operational risk management function, to ensure that they are adequate and that the overall operational risk management and measurement processes and systems remain effective over time. For the same reason the management body should be involved, on an ongoing basis, in the oversight of the control procedures of Internal Audit.

[MV 607]

Senior management should ensure that the following tasks are being addressed:

- Ensuring the soundness of risk management processes;
- Informing the management body – or a designated committee thereof – of material changes or exceptions from established policies that will materially impact the operations and the operational risk profile of the institution;
- Identifying and assessing the main risk drivers, based on information provided by the operational risk management function;
- Defining the tasks of the risk management unit and evaluating the adequacy of its professional skills;
- Monitoring and managing all sources of potential conflicts of interest;
- Establishing effective communication channels in order to ensure that all staff are aware of relevant policies and procedures;

- Defining the content of reporting to the management body or to different delegated bodies thereof (e.g., the Risk Committee);
- Examining reports from Internal Audit on operational risk management and measurement processes and systems; and
- Adequately assessing operational risk inherent in new areas (products, activities, processes, and systems) before they are introduced, and identifying risks tied to new product development and other significant changes in order to ensure that the risk profiles of product lines are updated regularly.

[MV 608]

The operational risk management function designs, develops, implements, and executes risk management and measurement processes and systems.

[MV 609]

The Internal Audit should provide an assessment of the overall adequacy of the operational risk framework, as well as of the operational risk management function.

#### **2.4. Management Body, Concentration risk**

[Concentration 1]

**All institutions should have clear policies and key procedures ultimately approved by the management body<sup>139</sup> in relation to exposure to concentration risk.**

Institutions should have a clear and transparent concentration risk policy, ad part of the broader credit risk process, which is clearly and properly documented and approved by the management body. It should be subject to regular review to take account of changes in risk appetite and the business environment.

When devising their policies and procedures and when carrying out their review, institutions should bear in mind the CEBS guidelines on internal governance<sup>140</sup>.

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<sup>139</sup> As referred to in Article 11 of the Directive 2006/48/EC

## **2.5. Management Body, Stress Testing**

[ST 11]

**The management body has the ultimate responsibility for the overall stress testing framework. Where appropriate the management body can delegate certain aspects of this framework to specific risk committees or senior management, keeping the effective oversight./**

- even if the identification of risk drivers obviously involves experts within the institution such as economists, traders or business managers, the involvement of the management body in the stress testing framework and of senior management in the stress testing design is essential to ensure they buy into the process. In this perspective, the management body should approve the institution's overall stress testing framework and senior management should approve the design of the sensitivity analyses or scenario tests.
- both the management body and senior management should formally consider the results and senior management should come up with a clear understanding of their implications, keeping in mind the risk appetite of the institution. While interpreting the results, senior management should be aware of the limitations of the stress tests performed (e.g. probability of the event occurring or judgmental bias in the stress test's specification).

## **2.6. Management Body, Outsourcing**

[OS 2]

**The ultimate responsibility for the proper management of the risks associated with outsourcing or the outsourced activities lies with an outsourcing institution's senior management.**

1. All outsourcing regimes should ensure that the outsourcing of functions to an outsourcing service provider does not impair the supervision of the outsourcing institution.
2. Responsibility for outsourced functions must always be retained by the outsourcing institution. The outsourcing of functions does not relieve an outsourcing institution of its regulatory responsibilities for its authorized activities or the function concerned.

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<sup>140</sup> See CEBS Guidelines on the Application of the Supervisory Review Process under Pillar 2, Charter 2.1

3. Outsourcing institutions should be required to retain adequate core competence at a senior operational level in house to enable them to have the capability to resume direct control over an outsourced activity, in extremis.

4. Outsourcing shall not affect managers' full and unrestricted responsibilities under applicable legislation (e.g. under banking law).

[OS 3]

**Outsourcing arrangements can never result in the delegation of senior management's responsibility.**

The outsourcing of core management functions is considered generally to be incompatible with the senior management's obligation to run the enterprise under their own responsibility. Core management functions include, inter alia, setting the risk strategy, the risk policy, and, accordingly, the risk-bearing capacity of the institution. Hence, management functions such as the setting of strategies and policies in respect of the authorised entity's risk profile and control, the oversight of the operation of the entity's processes, and the final responsibility towards customers and supervisors should not be outsourced.

### **3. Internal Control**

#### **3.1. General**

[SRP, IG 18]

**There should be effective internal control systems and reliable information systems covering all significant activities of the institution.**

a. A critical component of an institution's activities is the establishment and maintenance of management information systems that cover the full range of its activities. This information is typically provided through both electronic and non-electronic means. Institutions must be particularly aware of the organisational and internal control requirements related to processing information in an electronic form, and of the necessity to have an adequate audit trail. Management decision-making could be adversely affected by unreliable or misleading information provided by systems that are poorly designed and controlled.

b. Information systems, including those that hold and use data in electronic form, must be secure, independently monitored and supported by adequate contingency arrangements.

[SRP, IG 14]

**Institutions should establish, making adequate allowance for the principle of proportionality, the following three primary functions in order to implement an effective and comprehensive system of internal control in all areas of the institution, namely (i) risk control function, (ii) compliance function, and (iii) internal audit function.**

a. These internal control functions should be independent of the business lines they monitor and control.

b. A control function can generally be regarded as independent if the following conditions are met:

- The control function staff do not perform any tasks that fall within the scope of the activities that the control function is intended to monitor and control.
- The control function is organizationally separate from the activities it is assigned to monitor and control. The head of the control function is subordinated to a person who has no responsibilities for managing the activities that are being monitored and controlled.
- The head of the control function reports directly to the management body (both supervisory and management functions) and/or the audit committee, and is present at least once a year at meetings of the body it reports to.
- The remuneration of the control function staff is not linked to the performance of the activities that the control function is intended to monitor and control.

c. These internal control functions (i.e. risk control, compliance and internal audit) should also be organizationally independent from each other, since they perform different functions. The reporting lines should run directly from the above-mentioned functions to the management body (both supervisory and management functions). Furthermore, it is the responsibility of the management body to ensure that the risk control function, the compliance function and the internal audit function all have sufficient resources (well-qualified and experienced staff, as well as a sufficient number of staff) at their disposal.

d. It may not be practical for smaller institutions to meet all of the above conditions; in such cases they may take other measures provided they can show how any real or potential conflicts of interest are avoided or mitigated.

[SRP, IG 19];

**The management body should put in place appropriate internal alert procedures for communicating internal governance concerns from the staff.**

a. Institutions are encouraged to adopt appropriate internal alert procedures that staff can use to draw attention to significant and legitimate concerns regarding matters connected with internal governance. These procedures should respect the confidentiality of the staff who raise such concerns. There should be an opportunity to raise these kinds of concerns outside regular reporting lines (e.g. to the head of compliance or internal auditor). The procedures on how to make their concerns known should be made available in writing to all staff within the institution. Information provided by the staff through the alert procedure should, if relevant, be made available to the management body (both supervisory and management functions).

b. In some Member States, in addition to any internal alert procedures within the institution, there may also be a possibility for staff to inform the supervisory authority of their concerns of this type.

### **3.2. Risk Control Function**

#### **General**

[SRP, IG 15]

**The risk control function should ensure compliance with risk policies.**

a. Risk control requires an appropriate control structure. This should include the establishment of control policies and procedures as well as verification that the control policies and procedures are complied with. Control activities should be defined at the appropriate level.

b. The risk control function is designed to address the risks that the institution identifies through its risk assessment process. In large, complex and sophisticated institutions, a risk control function should be established to monitor each of the material risks to which the institution is exposed. The risk control function should report to the management body (both supervisory and management functions) and other relevant staff. The management body (management function) should continuously evaluate the risks affecting the achievement of its goals, and should react to changing circumstances and conditions.

## Risk Control, Model Validation (IRB)

### Internal reporting

[MV 429]

Internal ratings-based analysis of the institution's credit risk profile should be an essential part of the internal reporting system. The recipients of the reporting should include not only the management body and senior management, but also all of the internal functions responsible for originating and monitoring credit risks. The frequency and content of reporting should be formally approved by both the management body and senior management.

[MV 430]

The frequency and scope of reporting should be set according to the nature of the recipient and the level of risk.

The level of risk could depend, for example, on the ratings or the size of exposures

[MV 431]

Reporting to senior management should enable it to monitor the evolution of credit risk in the overall portfolio. The scope of information (e.g., rating classes, PD bands) to be included in the internal reporting may vary according to the nature, size, and degree of complexity of the business and the institution.

[MV 432]

The minimum requirements of the CRD relating to reporting are specified in Annex VII, Part 4, Paragraph 126. Good practice in satisfying these requirements could include providing the following information:

- A description of the rated portfolios (amounts, number of obligors, PDs per grade, percentage of coverage with ratings with respect to the total portfolio, breakdown by entities, sectors, subportfolios, and business units);
- The distribution of the overall portfolio according to rating grades, PD bands, and LGD grades, and a comparison with the previous year;

- A comparison of realised default rates (and loss given default and credit Conversion Factors for institutions on advanced approaches) against expectations;
- The results of stress tests;
- An estimate of regulatory capital requirements and economic capital; and
- The portfolio's migration across rating grades.

[MV 433]

In addition to the reporting mentioned above, the Credit Risk Control Unit should address specific reports to senior management relating to the rating system review process. It is the responsibility of the CRCU to provide coherent reporting that is clearly related to target variables.

## **Credit Risk Control Unit (CRCU)**

### ***Introduction***

[MV 416]

Annex VII, Part 4, Paragraph 127 of the [Directive 2006/48/EC](#) refers to the 'Credit Risk Control Unit' (CRCU). It is useful at this point to distinguish between the organisational part and the functional part (the Credit Risk Control function) of this term. As part of the internal control function, the Credit Risk Control function should be independent from the business lines it monitors and controls. It is designed and implemented to address the risks that the institution identifies through the risk assessment process.

[MV 417]

Large and complex institutions should establish a risk control unit to monitor each of the material risks (within material business lines) to which the institution is exposed. The risk control unit should report to senior management and other relevant staff.

[MV 418]

Although in most cases the organisational part of the CRCU and the CRC function would be identical (and consequently the CRCU would encompass only people responsible for fulfilling the Credit Risk Control function), the

CRCU could, as an organisational unit, encompass both the people responsible for the design of the model and the people responsible for the independent review of the model.

[MV 419]

As far as the design of the rating models is concerned, the CRD affirms that the CRCU “shall be responsible for the design or selection, implementation, oversight and performance of the rating systems” (Annex VII, Part 4, Paragraph 127). It thus appears that the two broad functions of model review and model development and selection could be performed by the same unit. A rationale for this structure could be found in the skills and experience of the people who design or select models, which sometimes make them the only ones able to review and validate models. Furthermore, the separation of the two units could be burdensome, especially in smaller institutions.

[MV 420]

The coexistence of both functions in the same unit should not be seen as an obstacle; any potential for lack of objectivity should be offset with controls, administered by the Internal audit or another comparable independent audit unit, to prevent bias from affecting the rating process.

[MV 427]

The credit risk control unit is responsible for proper functioning of the rating systems; it submits rating systems for approval.

### ***Goal/Scope of activity***

[MV 434]

The main goal of the Credit Risk Control Unit (Annex VII, Part IV, Paragraphs 127 to 129 of the Directive 2006/48/EC) is to ensure, on a regular basis, that the rating system and all of its components – rating assignments, parameter estimation, data collection, and oversight – are functioning as intended. The Credit Risk Control Unit should perform the following tasks, among others:

- Design of the rating system (perform or review);
- Ongoing review of the rating criteria and model development;
- Verification of the accuracy of all riskrating grades;

- Assessment of consistency across industries, portfolios, and geographical regions;
- Assessment of model use;
- Analysis of the reasons for overrides and exceptions;
- Quantification process (perform or review);
- Backtesting;
- Analysis of actual and predicted ratings transitions; and
- Benchmarking against third-party data sources.

[MV 435]

The results of the CRCU's review should be reported to senior management at least twice annually.

### ***Proportionality***

[MV 436]

Establishing a specific unit responsible for developing and designing the rating system, and a separate unit that contains only the CRC function, could be burdensome, especially for smaller and less sophisticated institutions. Implementing the minimum requirements of the CRD could, in practice, impose some redundancies from an organisational point of view (e.g., a Credit Risk Control Unit composed of only a handful of officers).

[MV 437]

In these cases, national supervisors can decide to make specific adjustments to these guidelines, taking into account the nature, size, and level of complexity of the business performed by the institutions applying for the use of the IRB approach.

For example, in some small institutions, the Credit Risk Control function is also responsible for the rating assignment process for specific obligors. This may be due to staff scarcity, or because staff in the CRC function who are directly involved in model building and review are more skilled in the assignment of ratings, especially to counterparties whose creditworthiness is difficult to assess (e.g., Specialised Lending, large and complex groups).

[MV 438]

However, such adjustments should not undermine the principle of independence of the CRC function or the overall soundness of the control environment.

[MV 439]

In this case, a lack of objectivity may arise because the model builder may have an excessive degree of confidence in the model output, and may become more tolerant towards potential failures or biases. Therefore, depending on the circumstances, the coexistence of the two tasks may be regarded either as an exceptional (permanent) or a transitional solution, in the latter case to be overcome as soon as possible. The coexistence should be made transparent in any case.

### ***Location of the CRC function within the organizational structure***

[MV 440]

Any attempt to specify where in the organisational structure of an institution the CRC function should be located could be to some extent counterproductive, for the following reasons:

- The activities of the CRC function span multiple areas or business units.
- Institutions will choose a structure that fits their management and oversight frameworks.

[MV 441]

A minimum requirement, however, could be to make the CRC function depend directly on senior management, wherever the unit is located within the organisation. Part of the duties of Internal Audit should be to review whether the location of the CRC function could reduce its independence.

[MV 442]

The CRC function should always have high standing within the organisation, and should be staffed by individuals possessing the requisite stature, skills, and experience.

***Independence of the CRC function from the functions responsible for originating or renewing exposures***

[MV 443]

Lack of independence of the Credit Risk Control function and pressures from relationship managers could seriously undermine the effectiveness and soundness of the IRB system. The problem is how to ensure and enforce independence. A control function can generally be regarded as independent if the following conditions are met:

- The staff of the control function should not have any tasks to perform that fall within the scope of the activities that the control function is assigned to monitor and control.
- The control function should be organizationally separate from the activities it is assigned to monitor and control. The head of the control function should be subordinated to a person who has no responsibility for managing the activities that are being monitored and controlled (in this case these activities would be originating and renewing exposures).
- The head of the control function should report directly both to the management body and senior management and/or the audit committee.
- The remuneration of the control function staff should not be linked to the performance of the activities that the control function is assigned to monitor and control.

[MV 444]

There is no single way to achieve independence, but rather different options.

One option is to make the CRCU depend directly on senior management. Another option could be to maintain a separation between the control functions and the commercial area/relationship managers, up to the level of the responsible member of senior management.

[MV 445]

Whatever option is adopted by the institution, part of the duties of Internal Audit should be to determine the 'real' degree of independence of the CRC function.

[MV 446]

A strict separation between the commercial function and the CRC unit (but not the CRC function) could have undesirable effects. For example, models developed by risk managers without the contribution of relationship managers could be rejected by the latter, or staff from the commercial lines could be tempted to force some of the model's inputs (especially qualitative inputs) in order to 'adjust' the model's outcome to their assessments (affecting the use test). Consequently, staff from the credit risk control unit and commercial department should cooperate actively in the development of the model. In order to ensure the desired independence after model development is complete, the exchange of information could best be through committees.

### **Independence / conflict of interests in rating assignment**

[MV 451]

Independence in the rating assignment process depends on how an institution is organised and on how it conducts its lending activities. Although rating processes may vary by institution or portfolio, they generally involve an 'assignor' and an 'approver,' whose tasks and responsibilities could differ. (Their tasks and responsibilities may vary also by portfolio.) Some of the most common situations are:

#### **Rating assignment made by relationship managers**

[MV 452]

Some institutions have adopted 'judgmental approaches' for assigning ratings to counterparties. Such approaches entail some responsibilities for relationship managers, who are called upon to assess the creditworthiness of the obligors based on qualitative questionnaires or specific templates.

[MV 453]

As relationship managers are primarily responsible for marketing the institution's products and services, and their compensation is usually tied to the volume of business they generate, giving them responsibilities for assigning and approving ratings would give rise to an inherent conflict of interest. Credit quality and the ability to produce accurate risk ratings are generally not major factors in a relationship manager's compensation. Relationship managers may also become too close to the borrower to maintain their objectivity and remain unbiased.

[MV 454]

For non-retail business institutions should not delegate rating responsibility (assignment or review) entirely to relationship managers. Relationship managers should only play a partial role in the rating assignment process, carrying out preliminary credit assessment to be validated afterwards by other 'independent' officers (see paragraphs 460 and 461 of this paper, on "Rating assignment based on mixed approach"). In this case, institutions should offset the potential lack of independence with controls to prevent the bias from affecting the rating process. Such controls should operate in practice and would include, at a minimum, a comprehensive, independent review of ratings by risk control functions (for example, offsite monitoring by the credit controllers, analysis of rating performances by the CRCU, and onsite review by Internal Audit or another comparable independent audit unit). An additional way to enforce the independence of the rating assignment is to link the compensation of the relationship manager to risk-adjusted performance measures (such as RAROC) based on the outputs of the IRB system.

### **Rating assignment by models whose outcome cannot be modified by users**

[MV 455]

This solution is typically adopted for retail and consumer banking, where the large number of loans in small amounts make it essential to minimise the cost of rating assignment. In this case, the assessment of creditworthiness is basically made by the model itself.

[MV 456]

Biases in model-based rating assignments could stem only from errors or fraud in the input of relevant data. Consequently, independent vetting of input data becomes crucial. The CRC function should verify on an ongoing basis that the model remains predictive of risk, by means of specific validation sessions based, for example, on back-testing or benchmarking of model outcomes.

## **Rating assignment by independent credit officers/ rating committees**

[MV 457]

Some institutions assign sole responsibility for assigning and approving ratings to credit officers or rating committees that report to an independent credit function. This solution is aimed at separating the people who 'own' the relationship and propose new credit applications from the people who are ultimately responsible for the rating assignment. In addition to assigning and approving ratings, credit officers regularly monitor the condition of obligors and refresh ratings as necessary.

[MV 458]

In this approach, the relationship between relationship managers and credit officers, and the organisational structure of the institution, become crucial, essentially because the 'true' degree of independence of the credit officer/rating committee could be difficult to evaluate in practice, especially for the largest counterparties for which approval limits are set at the level of senior management or the management body. Another potential disadvantage of this structure is that credit officers may have limited access to borrower information. This could affect the discriminative and predictive power of ratings.

[MV 459]

The role played by the CRC function therefore becomes crucial, especially with regard to the assessment of ratings' performance and the ongoing review of the rating system.

## **Rating assignment based on mixed approach**

[MV 460]

A mixed approach is sometimes used for exposures to Corporates or SMEs. The following example is illustrative.

The rating assignment is initially determined by statistical or judgmental models. If the relationship manager, who is responsible for data input, is satisfied with the model's outcome, then the final rating will be the model's rating. If, on the other hand, the relationship manager disagrees with the model's outcome, he can propose an 'override' to a senior officer – or to a rating committee, according to the size of the exposure – which is ultimately responsible for confirming the model's rating or changing it.

For smaller clients (such as SMEs in retail portfolios), relationship managers are sometimes free to change the model's rating within certain limits (they typically can upgrade only by a few notches, while they are free to downgrade as much as they want).

[MV 461]

When a mixed approach is used, the features of the models combined with the organisational structure of the institution become crucial. For example, if the rating model is not suited to a particular class of obligors or facilities, there will probably be a large number of overrides, and relationship managers may also be tempted to 'cheat' the model. Institutions should therefore ensure that all relevant information is considered in the rating assignment process, and should take the necessary steps to identify potential rating errors. In addition, controls are needed to ensure accuracy of data inputs. Finally, all 'management overrides' should be duly motivated by the relationship managers and all relevant decisions (both confirmations and rejections of proposed overrides) should be stored, in order to allow the CRC function to perform back-testing correctly.

## **Risk Control, Model Validation (AMA)**

### **Internal reporting**

[MV 610]

Operational risk reporting should be an essential part of the internal reporting system and should support the proactive management of operational risk. The recipients of the reporting should be the management body, senior management, Internal Audit, the Risk Committee and/or the Internal Control Committees (where established), and, where appropriate, the internal functions responsible for the identifying, assessing, monitoring, mitigating, and controlling operational risks. These internal functions could include, for example, business functions, central functions (such as IT, Plan and Management control, and accounting), and risk functions.

[MV 611]

The frequency and content of reporting should be formally approved by both the management body and senior management. Senior management should ensure the ongoing appropriateness of the reporting framework.

[MV 612]

The frequency, content, and format of reporting should depend on the recipient and on how the information will be used. Possible uses include strategic and financial planning, day-to-day management, operational risk management and measurement, market disclosure, etc.

[MV 613]

The scope of information included in internal reporting may vary according to the nature, size, and degree of complexity of the business, as well as of the institution. As a general rule, the riskier the business, the more detailed the information to be provided. The frequency and format of the internal reporting should be consistent with the level of risk.

[MV 614]

The design of the reporting framework is the responsibility of the institution. However, reporting could include:

- Estimates of regulatory and economic capital;
- New or improved management policies, procedures, and practices (e.g., changes in the business environment, business practices, and internal control factors);
- Risk reduction and risk transfer strategies (e.g., the effect of any expected loss deductions, cost-benefit analysis of insurance policies, mitigation and corrective actions on the business line/event type exposure and/or losses, cost-benefit analysis of the mitigation actions);
- Operational risk exposure (e.g., description of key operational risk events and drivers, and the distribution, trend, and migration of the operational risk exposure across business lines);
- Internal and (where relevant) external loss experience (e.g., event type loss analysis and comparison in term of trends, seasonality, geographical distribution, etc.);
- Identification and assessment of vulnerability areas (e.g., risk assessments, key risk indicators); and
- Quality improvements in operational risk management and measurement processes and systems.

## Operational Risk Management Function

[MV 615]

The Operational risk management function (ORMF) should ensure, on a regular basis that the institution's operational risk measurement processes and risk management systems and all of their components are functioning as intended. The ORMF should have sufficient resources and skills in operational risk management and measurement methods and knowledge of the processes of the institution.

[MV 616]

The Operational risk management function should ensure that the following tasks and areas (among others) are performed or covered on an ongoing basis:

- The processes related to the definition, documentation, and collection of the four AMA elements;
- Measurement methodology;
- Monitoring and reporting systems;
- Verifying the fulfillment of the qualifying criteria, and, in particular, of the use test;
- Operational risk quantification and allocation processes, including the calculation of any haircuts (EL, Dependence, Insurance), where sufficient data are available, back-testing and benchmarking, and the methodology for the allocation keys.

[MV 617]

The CRD does not specify how and where the internal validation of the AMA measurement models should take place. Ideally, the people responsible for the internal validation of measurement systems and management processes should not be the same as the people responsible for their design (see paragraph 418 of these Guidelines, which introduces a similar principle in the context of credit risk). However, on an exceptional or temporary basis, it can be acceptable that the role of validation of the AMA measurement systems and management processes is undertaken by the same function as the one involved in designing, developing, and implementing the operational risk framework.

[MV 618]

Any potential lack of objectivity should be offset by an independent review, as required by the fifth principle of paragraph 583 of these Guidelines. Institutions are encouraged to move to an independent internal validation process as soon as possible.

[MV 619]

Any attempt to specify where in the organisational structure of an institution the ORMF should be located could be to some extent counterproductive, for the following reasons:

- The activities of the ORMF could span multiple areas and business units;
- Institutions will choose a structure that fits their management and oversight frameworks.

[MV 620]

Institutions generally have a central operational risk unit and some operational risk staff in the local entities (units, businesses, etc.). Where this is the case, the institution should ensure that the local operational risk staff follows the guidelines set by the central operational risk unit. There should be clear responsibilities and reporting lines. The Internal Audit should perform specific examinations in order to assess the 'real' degree of independence of the ORMF.

### **3.3. *Compliance Function***

[SRP, IG 16]

**The compliance function should identify and assess compliance risk.**

a. It is the responsibility of the management body (both supervisory and management functions) to approve the institution's policy with regards to compliance risk. Compliance risk is defined as the risk of legal or regulatory sanctions, material financial loss, or loss to reputation an institution may suffer as a result of its failure to comply with compliance laws, rules and standards.

b. In order to fulfill this responsibility the management body (management function) should establish and communicate a compliance policy, ensure that it is observed, and report to the management body (supervisory function) on the management of the compliance risk by the

institution. Furthermore, the management function should establish a permanent and effective compliance function.

c. The compliance function should advise the management function on compliance laws, rules and standards, including keeping them informed on developments in the area. The compliance function can also assess the possible impact of any changes in the legal environment on the operations of the institution. The compliance function also has the role of verifying that new products and new procedures are in compliance with the current legal environment and any known amendments to the legislation that has not yet entered into force.

d. In less-complex and smaller institutions the tasks of the compliance function may be performed by the risk control function or internal audit.

### **3.4. Internal Audit Function**

#### **General**

[SRP, IG 17]

**The internal audit function should allow the management body to ensure that the quality of the internal controls is both effective and efficient.**

a. The management body (both supervisory and management functions) is responsible for establishing the internal control framework in compliance with regulatory requirements. The internal audit function is responsible for the assessment of the adequacy of internal controls and should report its findings to the management body (both supervisory and management functions)

b. The internal audit function should have unfettered access to the management body (both supervisory and management functions) and/or to the audit committee where applicable. Any suggestions by internal audit for material improvements in internal controls should be reported directly to the management body (both supervisory and management functions). All audit recommendations should be subject to a formal follow-up procedure by the respective level of management, in order to ensure (and report) their resolution.

c. The internal audit function should evaluate the adequacy of the internal control framework of the institution (including the risk control and compliance functions) and report its findings. It should also have unfettered access to relevant documents and information in all business lines. It should evaluate the compliance of all activities and divisions with the institution's policies and procedures. The internal audit function must also evaluate whether existing policies and procedures remain adequate.

#### **Internal Audit, Model Validation (IRB)**

[MV 447]

The Internal Audit function reviews whether the institution's control systems for internal ratings and related parameters are robust (Annex VII, Part 4, Paragraph 130 of the [Directive 2006/48/EC](#)). It should therefore have an appropriate understanding of all the processes of the rating systems, including those processes which generate the estimates of risk parameters. As part of its review of control mechanisms, Internal Audit will evaluate the depth, scope, and quality of the Credit Risk Control function's work. Internal Audit may also conduct tests to ensure that Credit Risk Control function's conclusions are well founded. Internal Audit should also review the adequacy of the IT infrastructure and data

maintenance. For institutions using statistical models, Internal Audit should conduct tests (for example, on specific business units) in order to check data input processes.

[MV 448]

Internal Audit or another comparable independent audit unit should report at least annually to both the management body and senior management on the institution's compliance with the IRB requirements.

[MV 449]

In order to strengthen its independence, Internal Audit should not be directly involved in model design/selection. Although not directly related to independence (but rather to credibility), Internal Audit units should always have a high standing within the organisation and should be staffed by individuals possessing the requisite stature, skills, and experience.

[MV 450]

Notwithstanding the need for independence, some cooperation between Internal Audit and the CRC function can be desirable, for example in order to address potential weaknesses or biases in the rating system. For instance, information on overrides detected by the CRC function in a specific portfolio or business unit should be passed on to Internal Audit so that it can assess whether the overrides stem from model biases (for example, because the model is unfit to produce ratings for specific businesses) or from a lack of independence of relationship managers. Nevertheless, it should be clear that the CRC function has sole responsibility for the rating systems' performance. The audit function should not be involved in day-to-day operations such as reviewing each individual rating assignment.

[MV 428]

The Internal Audit or another comparable independent auditing unit should provide an assessment of the overall adequacy of the internal control system and of the credit risk control function.

### **3.4.3. Internal Audit, Model Validation (AMA)**

[MV 621]

The central role of Internal Audit's review of the operational risk management framework is to ensure the effectiveness of the institution's operational risk management processes and measurement systems and the work of the ORMF, and to verify compliance with the AMA standards.

[MV 622]

As part of its activities, Internal Audit should develop a programme for reviewing the operational risk framework that covers all significant activities – including outsourced activities – that expose the institution to material operational risk. This programme should be regularly updated with regard to:

- Development of internal processes for the identifying, assessing, monitoring, controlling, and mitigating operational risk; and
- Implementation of new products, processes, and systems which expose the institution to material operational risk.

[MV 623]

Internal Audit activity should also cover issues such as the adequacy of the IT infrastructure, data collections, and data maintenance. Specific tests should be performed in order to check the data input process.

[MV 624]

Internal Audit functions should be staffed by individuals possessing the requisite skills and experience. It is important that they be familiar with the institution's strategy and its processes for identifying, assessing, monitoring, controlling, and mitigating operational risk

[MV 625]

Some cooperation between Internal Audit and the ORMF is permissible, especially in some operational risk related activities and processes where Internal Audit's experience and skills are well developed (for example, analysis of processes, loss data collections, risk and control assessments, etc.). However, cooperation with the ORMF should not jeopardise the independence of Internal Audit. Whatever advice or information may be

provided by Internal Audit, designing, implementing, and updating the operational risk framework remains the exclusive responsibility of the ORMF, and Internal Audit should not be involved in day-to-day operational risk activities.

### ***3.5. Reliance on the work of external auditors in the review process***

[MV 462]

The CRD contains several references to tasks that should be performed by an independent assessment unit. For example, Annex X, Part 3, Paragraph 6 states that “the operational risk management processes and measurement systems shall be subject to regular reviews performed by internal and/or external auditors.” These reviews could be performed either by the institution’s internal unit or by an external auditor. As the external auditor may also be involved in performing the institution’s statutory audit, the question of independence arises.

[MV 463]

Supervisors will seek to understand the scope of an external audit review, and specifically whether particular subsidiaries are excluded from the review, perhaps on grounds of materiality. The purpose of this requirement is to ensure that the results of the external audit review are not incorrectly taken to apply to the subsidiaries.

[MV 464]

The management of an institution (subsidiary or otherwise) is responsible for, and has full, independent control over the review of the institution, regardless of whether that review is performed by an internal or external unit. The management of the institution should communicate directly with the assessment unit at all stages, and the assessment unit in turn should report directly to the management of the institution during the review.

[MV 465]

The external auditor may perform an independent assessment of a vendor’s technology only if there are no relationships (including commercial and/or marketing relationships) between any parts of the two companies that could compromise the independence of the assessment.

[MV 466]

An institution using a vendor's methodology should also perform a review through its own Internal Audit or other internal assessment unit, to ensure a thorough understanding of the vendor's methodologies. Such a review should be considered reliable only if it is performed by a unit (internal or external) that is sufficiently familiar with all aspects of the reviewed systems and methodologies.

#### **4. Public Disclosure and Transparency**

[SRP, IG 20]

**Institutions should meet the generally agreed transparency requirements in the conduct of their business.**

a. For major institutions, the expectations of investors, customers, rating agencies and others may require a higher degree of transparency.

b. Public disclosure is desirable in the following areas: the structure of the management body (both supervisory and management functions), basic organisational structure, the incentive/remuneration structure of the institution and the nature and extent of transactions with affiliates and related parties. Such disclosures enable interested parties to form a true and accurate assessment of the institution.

c. Institutions may also find it desirable to describe how their risk management, risk control, compliance and internal audit functions are organised. Finally, they may want to outline the major tasks performed by these functions, describe how performance is monitored by the management body (both supervisory and management functions), and describe how any necessary improvements are being implemented.

[SRP, IG 21]

**Each institution should present its current position and future prospects in a balanced, accurate and timely way.**

a. Information about the current position of the institution should comply with any legal requirements regarding the disclosure of such information. The information should be accurate, relevant, timely and accessible, in order to meet the needs of supervisors, investors, customers, clients, rating agencies, external credit assessment institutions (ECAIs), and the public.

b. In cases where ensuring a high degree of accuracy would delay the release of time-sensitive information, the institution should make a judgment as to the appropriate balance between timeliness and accuracy,

bearing in mind the requirement to provide a true and fair picture of the institution's situation. This reasoning should not be used to delay regular reporting requirements, and a satisfactory explanation of the circumstances warranting an exception should be provided.

c. Disclosures should include, but not be limited to, material information on the financial and operating results of the company, foreseeable risk factors and governance structures and policies.

## Appendix 2

### Consultation and Transparency on Guidelines

| Former Consultation Nr      | Final title of Guidelines or Consultation Papers                           | End of Public Consultation                      | Consultation Period | Date of current document |
|-----------------------------|----------------------------------------------------------------------------|-------------------------------------------------|---------------------|--------------------------|
| CP 01<br>(and CP01 revised) | Public statement of Consultation Practices                                 | 1 <sup>st</sup> consultation<br>31 July 2004    | 3 months            | 29 April 2004            |
|                             |                                                                            | 2 <sup>nd</sup> consultation<br>19 June 2007    | 3 months            | 5 August 2008            |
| CP02<br>(and CP02 revised)  | Guidelines on Outsourcing                                                  | 1 <sup>st</sup> consultation:<br>31 July 2004   | 3 months            | 14 December 2006         |
|                             |                                                                            | 2 <sup>nd</sup> consultation 6 July 2006        | 3 months            |                          |
| CP03<br>(and CP03 revised)  | Guidelines on Application of the Supervisory Review Process under Pillar 2 | 1 <sup>st</sup> consultation<br>31 August 2004  | 3 months            | 25 January 2006          |
|                             |                                                                            | 2 <sup>nd</sup> consultation<br>21 October 2005 | 4 months            |                          |
| CP04<br>(and CP04 revised)  | Guidelines on Common Reporting (COREP)                                     | 1 <sup>st</sup> consultation<br>30 April 2005   | 3 months            | 16 October 2006          |
|                             |                                                                            | 19 December 2007                                | 4 months            |                          |
| CP05                        | Supervisory                                                                | 24 June 2005                                    | 3 months            | 1 November               |

|                            |                                                                                                            |                   |            |                                    |
|----------------------------|------------------------------------------------------------------------------------------------------------|-------------------|------------|------------------------------------|
|                            | Disclosure                                                                                                 |                   |            | 2005                               |
| CP06 (and<br>CP06 revised) | Financial Reporting Framework (FINREP)                                                                     | 8 July 2005       | 3 months   | 15 December 2006<br>24 July 2007   |
| CP07                       | External Credit Assessment Institutions (ECAI) Recognition                                                 | 30 September 2005 | 3 months   | 20 January 2006                    |
| CP08                       | The role and tasks of CEBS                                                                                 | 28 October 2005   | 3 months   | 28 October 2005                    |
| CP09                       | Cooperation between consolidating and host supervisors                                                     | 8 November 2005   | 4 months   | 25 January 2006                    |
| CP10<br>(and CP10 revised) | Model Validation and Approval                                                                              | 30 October 2005   | 3,5 months | 4 April 2006                       |
| CP11 (a and b)             | a) Concentration Risk and<br>b) Interest Risk in the Banking Book (IRRBB) under Supervisory Review Process | 23 June 2006      | 3 months   | 3 October 2006<br>14 December 2006 |
| CP12                       | Stress Testing under the Supervisory Review Process                                                        | 30 September 2006 | 3 months   | 14 December 2006                   |
| CP13                       | Establishment of a mediation mechanism                                                                     | 19 June 2007      | 3 months   | 25 September 2007                  |
| CP14                       | First part of its advice to the                                                                            | 15 August         | 2 months   | 6 November                         |

|      |                                                                                                                |                 |          |      |
|------|----------------------------------------------------------------------------------------------------------------|-----------------|----------|------|
|      | European Commission on large exposures                                                                         | 2007            |          | 2007 |
| CP15 | Consultation Paper on risks arising from commodities business and from firms carrying out commodities business | 15 June 2007    | 6 weeks  |      |
| CP16 | Consultation Paper on the second part of its technical advice on large exposures                               | 7 December 2007 | 10 weeks |      |
| CP17 | Consultation Paper on its proposals for a common EU definition of Tier 1 hybrids                               | 7 December 2007 | 10 weeks |      |