

would have to clearly specify the frequency of review, as well as describe the oversight to be provided by management of the ratings process.

Banking organizations using the A-IRB approach would need to be able to generate sound measurements of the key risk inputs to the A-IRB capital formulas. Banking organizations would be able to rely on data based either on internal experience or generated by an external source, as long as the banking organization can demonstrate the relevance of external data to its own experience.

In assigning a rating to an obligor, a banking organization must assess the risk of default, taking into account possible adverse events that might increase the obligor's likelihood of default. The A-IRB supervisory standards in the supervisory guidance provide banking organizations with a degree of flexibility in determining precisely how to reflect adverse events in obligor ratings. However, banking organizations are required to clearly articulate the approach chosen, and to articulate the implications for capital planning and for capital adequacy during times of systematic economic stress. The Agencies recognize that banking organizations' internal risk rating systems may include a range of statistical models or other methods to assign borrower or facility ratings or to estimate key inputs. The burden of proof would remain on the banking organization as to whether a specific model or procedure satisfies the supervisory standards.

Risk Rating System Operations

The risk rating system would have to form an integral part of the loan approval process wherein ratings are assigned to all borrowers, guarantors, or facilities depending upon whether the extension of credit is wholesale or retail in nature. Any deviations from policies that govern the assignment of ratings must be clearly documented and monitored.

Data maintenance is another key aspect of risk rating system operations. Banking organizations would be expected to collect and store data on key borrower and facility characteristics. The data would have to be sufficiently detailed to allow for future reconsideration of the way in which obligors and facilities have been allocated to grades. Furthermore, banking organizations would have to collect, retain, and disclose data on aspects of their internal ratings as described under the disclosure section of this proposal.

Banking organizations would be required to have in place sound stress testing processes for use in the assessment of capital adequacy. Stress testing would have to involve identifying possible events or future changes in economic conditions that could have unfavorable effects on a banking organization's credit exposures. Specifically, institutions would need to assess the effect of certain specific conditions on their A-IRB regulatory capital requirements. The choice of test to be employed would remain with the individual banking organization provided the method selected is meaningful and reasonably conservative.

Corporate Governance and Oversight

The Agencies view the involvement of the board of directors and management as critical to the successful implementation of the A-IRB approach. The board of directors and management would be responsible for maintaining effective internal controls over the banking organization's information systems and processes for assessing adequacy of regulatory capital and determining regulatory capital charges consistent with this ANPR. All significant aspects of the rating and estimation processes would have to be approved by the banking organization's board of directors or a designated committee thereof and senior management. These parties would need to be fully aware of whether the system complies with the supervisory standards, makes use of the necessary data, and produces reliable quantitative estimates. Ongoing management reports would have to accurately capture the performance of the rating system.

Oversight would also need to involve independent credit risk control units responsible for ensuring the performance of the rating system, the accuracy of the ratings and parameter estimates, and overall compliance with supervisory standards and capital regulations. The Agencies believe it is critical that such units remain functionally independent from the personnel and management responsible for originating credit exposures. Among other responsibilities, the control units should be charged with testing and monitoring the appropriateness of the rating scale, verifying the consistent use of ratings for a given exposure type across the organization, and reviewing and documenting any changes to be made to the system.

Use of Internal Ratings

To qualify to use the A-IRB framework, a banking organization's

rating systems would have to form an integral part of its day-to-day credit risk management process. The Agencies expect that banking organizations would rely on their internal risk rating systems when making decisions about whether to extend credit as well as in their ongoing monitoring of credit exposures. For example, ratings information would have to be incorporated into other key processes, such as reserving determinations and when allocating economic capital internally.

Risk Quantification

Ratings quantification is the process of assigning values to the key risk components of the A-IRB approach: PD, LGD, EAD and M. With the exception of M, the risk components are unobservable and must be estimated. The estimates would have to be consistent with sound practice and supervisory standards. Banking organizations' rating system review and internal audit functions would need to serve as control mechanisms that ensure the process of rating assignments and quantification are functioning according to policy and that non-compliance or weaknesses are identified.

Validation of Internal Estimates

An equally important element would be a robust system for validating the accuracy and consistency of a banking organization's rating system, as well as the estimation of risk components. The standards in the supervisory guidance require that banking organizations use a broad range of validation tools, including evaluation of developmental evidence, ongoing monitoring of rating and quantification processes, benchmarking against alternative approaches, and comparison of outcomes with estimates. Details of the validation process would have to be consistent with the operation of the banking organization's rating system and data would have to be maintained and updated to support oversight and validation work. Banking organizations would have to have well-articulated standards for situations where deviations of realized values from expectations become significant enough to call the validity of the estimates into question. Rating systems with appropriate data and oversight feedback mechanisms should create an environment that promotes integrity and improvements in the rating system over time.

U.S. Supervisory Review

The primary Federal supervisor would be responsible for evaluating an institution's initial and ongoing