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Document 1: Draft Supervisory Guidance on Internal Ratings-Based Systems for Corporate Credit

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I. Introduction

A. Purpose

This document describes supervisory expectations for banking organizations (institutions) adopting the advanced internal ratings-based approach (IRB) for the determination of minimum regulatory risk-based capital requirements. The focus of this guidance is corporate credit portfolios. Retail, commercial real estate, securitizations, and other portfolios will be the focus of later guidance. This draft guidance should be considered with the advance notice of proposed rulemaking (ANPR) on revisions to the risk-based capital standard published elsewhere in today's **Federal Register**.

The primary objective of IRB is to enhance the sensitivity of regulatory capital requirements to credit risk. To accomplish that objective, IRB harnesses a bank's own risk rating and quantification capabilities. In general, the IRB approach reflects and extends recent developments in risk management and banking supervision. However, the degree to which any individual bank will need to modify its own credit risk management practices to deliver accurate and consistent IRB risk

parameters will vary from institution to institution.

This guidance is intended to provide supervisors and institutions with a clear description of the essential components and characteristics of an acceptable IRB framework. Toward that end, this document sets forth IRB system supervisory standards that are highlighted in bold and designated by the prefix "S." Whenever possible, these supervisory standards are principle-based to enable institutions to implement the framework flexibly. However, when prudential concerns or the need for standardization override the desire for flexibility, the supervisory standards are more detailed. Ultimately, institutions must have credit risk management practices that are consistent with the substance and spirit of the standards in this guidance.

The IRB conceptual framework outlined in this document is intended neither to dictate the precise manner by which institutions should seek to meet supervisory expectations, nor to provide technical guidance on how to develop such a framework. As institutions develop their IRB systems in anticipation of adopting them for regulatory capital purposes, supervisors will be evaluating, on an individual bank basis, the extent to which institutions meet the standards outlined in this document. In evaluating institutions, supervisors will rely on this supervisory guidance as well as examination procedures, which will be developed separately. This document assumes that readers are familiar with the proposed IRB approach to calculating minimum regulatory capital articulated in the ANPR.

B. Overview of Supervisory Expectations

Rigorous credit risk measurement is a necessary element of advanced risk management. Qualifying institutions will use their internal rating systems to associate a probability of default (PD) with each obligor grade, as well as a loss given default (LGD) with each credit facility. In addition, institutions will estimate exposure at default (EAD) and will calculate the effective remaining maturity (M) of credit facilities.

Qualifying institutions will be expected to have an IRB system consisting of four interdependent components:

- A system that assigns ratings and validates their accuracy (Chapter 1),
- A quantification process that translates risk ratings into IRB parameters (Chapter 2),
- A data maintenance system that supports the IRB system (Chapter 3), and,