

asymmetric treatment of obligor and loss severity ratings. Obligor ratings assign obligors to groups that are expected to experience common default frequencies across a number of years, some of which are years of general economic stress and some of which are not. In contrast, loss severity ratings (or estimates) must pertain to losses expected during periods with a high number of defaults—particular years that can be called stress conditions. For cases in which loss severities do not have a material degree of cyclical variability, use of a long-run default weighted average is appropriate, although stress condition LGD generally exceeds these averages.

#### Loss Severity Rating/LGD Granularity

S. Banks must have a sufficiently fine loss severity grading system or prediction model to avoid grouping facilities with widely varying LGDs together.

While there is no stated minimum number of loss severity grades, the systems that provide LGD estimates must be flexible enough to adequately segment facilities with significantly varying LGDs. Banks should have a sufficiently fine LGD grading system or LGD prediction model to avoid grouping facilities with widely varying LGDs together. For example, a bank using a loss severity rating-scale approach that has credit products with a variety of collateral packages or financing structures would be expected to have more LGD grades than those institutions with fewer options in their credit products.

#### Other Considerations of IRB Rating System Architecture

##### Timeliness of Ratings

S. All risk ratings must be updated whenever new relevant information is received, but must be updated at least annually.

A bank must have a policy that requires a dynamic ratings approach ensuring that obligor and loss severity ratings reflect current information. That policy must also specify minimum financial reporting and collateral valuation requirements. For example, at the time of servicing events, banks typically receive updated financial information on obligors. For cases in which loss severity grades or estimates are dependent on collateral values or other factors that change periodically, that policy must take into account the need to update these factors.

Banks' policies may include an alternative rating update timetable for exposures below a *de minimus* amount

that is justified by the lack of materiality of the potential impact on capital. For example, some banks use triggering events to prompt an update of their ratings on *de minimus* exposures rather than adhering to a specific timetable.

#### Multiple Ratings Systems

Some banks may develop one risk-rating system that can be used across the entire commercial loan portfolio. However, a bank can choose to deploy any number of rating systems as long as all exposures are assigned PD and LGD values. A different rating system could be used for each business line and each rating system could use a different rating scale. A bank could also use a different rating system for each business line with each system using a common rating scale. Rating models could be used for some portfolios and expert judgment systems for others. An institution's complexity and sophistication, as well as the size and range of products offered, will affect the types and numbers of rating systems employed.

While using a number of rating systems is feasible, such a practice might make it more difficult to meet supervisory standards. Each rating system must conform to the standards in this guidance and must be validated for accuracy and consistency. The requirement that each rating systems be calibrated to parameter values imposes the ultimate constraint, which is that ratings be applied consistently.

#### Recognition of the Risk Mitigation Benefits of Guarantees

S. Banks reflecting the risk-mitigating effect of guarantees must do so by either adjusting PDs or LGDs, but not both.

S. To recognize the risk-mitigating effects of guarantees, institutions must ensure that the written guarantee is evidenced by an unconditional and legally enforceable commitment to pay that remains in force until the debt is satisfied in full.

Adjustments for guarantees must be made in accordance with specific criteria contained in the bank's credit policy. The criteria should be plausible and intuitive, and should address the guarantor's ability and willingness to meet its obligations. Banks are expected to gather evidence that confirms the risk-mitigating effect of guarantees.

Other forms of written third-party support (for example, comfort letters or letters of awareness) that are not legally binding should not be used to adjust PD or LGD unless a bank can demonstrate through analysis of internal data the risk-mitigating effect of such support. Banks may not adjust PDs or LGDs to

reflect implied support or verbal assurances.

Regardless of the method used to recognize the risk-mitigating effects of guarantees, a bank must adopt an approach that is applied consistently over time and across the portfolio. Moreover, the onus is on the bank to demonstrate that its approach is supported by logic and empirical results. While guarantees may provide grounds for adjusting PD or LGD, they cannot result in a lower risk weight than that assigned to a similar direct obligation of the guarantor.<sup>3</sup>

#### Validation Process

S. IRB rating system architecture must be designed to ensure rating system accuracy.

As part of their IRB rating system architecture, banks must implement a process to ensure the accuracy of their rating systems. Rating system accuracy is defined as the combination of the following outcomes:

- The actual long-run average default frequency for each rating grade is not significantly greater than the PD assigned to that grade.
- The actual stress-condition loss rates experienced on defaulted facilities are not significantly greater than the LGD estimates assigned to those facilities.

Some differences across individual grades between observed outcomes and the estimated parameter inputs to the IRB equations can be expected. But if systematic differences suggest a bias toward lowering regulatory capital requirements, the integrity of the rating system (of either the PD or LGD dimensions or of both) becomes suspect. Validation is the set of activities designed to give the greatest possible assurances of ratings system accuracy.

S. Banks must have ongoing validation processes that include the review of developmental evidence, ongoing monitoring, and the comparison of predicted parameter values to actual outcomes (back-testing).

Validation is an integral part of the rating system architecture. Banks must have processes designed to give

<sup>3</sup> The probability that an obligor and a guarantor (who supports the obligor's debt) will both default on a debt is lower than the probability that either the obligor or the guarantor will default. This favorable risk-mitigation effect is known as the reduced likelihood of "double default." In determining their rating criteria and procedures, banks are not permitted to consider possible favorable effects of imperfect expected correlation between default events for the borrower and guarantor for purposes of regulatory capital requirements. Thus, the adjusted risk weight cannot reflect the risk mitigation of double default. The ANPR solicits public comment on the double-default issues.