

overridden. In addition, controls are needed to ensure accuracy of data inputs. When a bank uses a model to assign risk ratings, an individual obligor's rating is "transparent." However, the model itself is not "transparent" without a great deal of effort to document how the model functions.

C. Transparency

Transparency is the ability of a third party, such as rating system reviewers, auditors or bank supervisors, to observe how the rating system operates and to understand the pertinent characteristics of individual ratings.

S. IRB institutions must have a transparent rating system.

Transparency in a rating system is achieved through documentation that covers the following:

- The rating system's design, purpose, performance horizon, and performance standards;
- The rating assignment process, including procedures for adjustments and overrides;
- Rating definitions and criteria, scorecard criteria, and model specifications;
- Parameter estimates and the process for their estimation;
- Definition of the data elements to be warehoused to support controls, oversight, validation, and parameter estimation; and
- Specific responsibilities of, and performance standards for, individuals and units involved in the rating system and its oversight.

Transparency allows third parties (such as rating system review, auditors, or supervisors) to evaluate whether the rating system is performing as intended. Without transparency, it is difficult to hold people accountable for ratings errors and to validate the performance of the system.

S. Rating criteria must be clear and specific and must include qualitative and quantitative factors.

To produce transparent individual ratings, a bank's policies must contain clear, detailed ratings definitions. Banks should specify criteria for each factor that raters must consider, which may require unique rating definitions for certain industries. Banks should consider criteria for factors such as liquidity, sales and profitability, debt service and fixed charge coverage, minimum equity support, position within the industry, strength of management. A rating system with vague criteria or one merely defined by PDs or LGDs is not transparent. For example, the following rating definitions are not transparent because

they require the rater to do too much interpreting:

Borrower exhibits satisfactory quality and demonstrates acceptable principal and interest repayment capacity in the near term.

Lower tier company in a cyclical industry. Unbalanced position with tight liquidity and high leverage. Declining or erratic profitability and marginal debt service capacity. Management is untested.

D. Accountability

"Accountability" is holding people responsible for their actions and establishing adverse consequences for inaccurate ratings.

S. Policies must identify the parties responsible for rating accuracy and rating system performance.

For accountability to be effective, it should be both observable and ingrained in the culture. Persons who assign and approve rate credits, derive parameter estimates, or oversee rating systems must be held accountable for complying with rating system policies and ensuring that aspects of the rating system within their control are as unbiased and accurate as possible. These persons must have the tools and resources necessary to carry out their responsibilities, and their performance should be evaluated against clear and specific objectives documented in policy.

Responsibility for Assigning Ratings

S. Individuals must be held accountable for complying with rating system policies and for assigning accurate ratings, and their performance and compensation must be linked to well-defined measurable performance standards.

Responsibilities of raters should be clear, and performance should be measured against specific objectives. Performance evaluation and incentive compensation should be tied to performance goals. Examples of performance measures include:

- Number and frequency of rating errors,
- Significance of errors (for example, multiple downgrades), and
- Proper and consistent application of criteria, including override criteria.

Responsibility for Rating System Performance

Just as individuals will be held accountable for the accuracy of ratings, an individual must be held responsible for the overall performance of the rating system. This individual must ensure that the rating system and all of its component parts—rating assignments,

parameter estimation, data collection, control and oversight mechanisms—are functioning as intended. While these components often are housed within separate units of the organization, an individual must be responsible for ensuring that the parts work together effectively and efficiently.

E. Use of Ratings

S. Ratings used for regulatory capital must be the same ratings used to guide day-to-day credit risk management activities.

The different uses and applications of the risk-rating system's outputs should promote greater accuracy and consistency of credit-risk evaluations across an organization. Ratings and the associated default, loss, and EAD estimates need to be incorporated within the credit-risk management, internal capital allocation, and corporate governance functions of IRB banks.

S. Banks that use parameter estimates for risk management that are different from those used for regulatory capital must provide a well-documented rationale for the differences.

PD and LGD parameters used for regulatory capital purposes may not be appropriate for other uses purposes. For example, PD estimates used to estimate reserve needs could reflect current economic conditions that are different from the longer term view appropriate to calculations of regulatory capital. When banks employ different estimates, those parameters must be defensible and supported by the following:

- Qualitative and quantitative analysis of the logic and rationale for the difference(s); and
- Senior management approval of the difference(s).

F. Rating System Review (RSR)

S. Banks must have a comprehensive, coordinated, independent review process to ensure that ratings are accurate and that the rating system is performing as intended.

Rating system review (RSR) ensures that the rating system as a whole is functioning as intended. A broad range of responsibilities come under RSR's purview, as outlined in Table 4.2:

TABLE 4.2.—RESPONSIBILITIES OF RATING SYSTEM REVIEW

Scope of Review:
Design of the rating system.
Compliance with policies and procedures, including application of criteria.
Check of all risk-rating grades for accuracy.
Consistency across industries/portfolios/geographies.