

TABLE 4.2.—RESPONSIBILITIES OF RATING SYSTEM REVIEW—Continued

Model development.
Model use, including inputs and outputs.
Overrides and policy exceptions.
Quantification process.
Back-testing (perform or review).
Actual and predicted ratings transitions.
Benchmarking against third-party data sources (perform or review).
Adequacy of data maintenance.
<i>Analysis and Reporting:</i>
Identify errors and flaws.
Recommend corrective action.

For each of these responsibilities, RSR is largely checking and confirming the work of others and ensuring that the rating system's components work well together. RSR's testing and review should identify current and potential weaknesses and should lead to recommendations and corrective action such as

- Adjusting policies and procedures,
- Requiring additional training of staff,
- Investing in infrastructure improvements,
- Adjusting rating criteria, and
- Adjusting parameter estimates.

S. Rating system review must report significant findings to senior management and the board quarterly.

RSR's role is to identify issues and areas of concern and report findings to the area that is accountable. When issues are systematic, RSR should bring them to the attention of senior management and the board.

The activities of this function could be distributed across multiple areas or housed within one unit. Organizations will choose a structure that fits within their management and oversight framework. These units must always have high standing within the organization and should be staffed by individuals possessing the requisite stature, skills, and experience.

Like internal audit, RSR must be independent from all in-house designers and developers (that is, system and model designers) and raters (that is, ratings and parameter assigners) in the risk-rating process. RSR's independence eliminates potential conflicts of interest and gives the group credibility when it reports findings and conclusions to the board and senior management.

#### G. Internal Audit

S. An independent internal audit function must determine whether rating system controls function as intended.

S. Internal audit must evaluate annually whether the bank is in compliance with the risk-based capital regulation and supervisory guidance.

Internal audit determines whether the bank's system of controls over internal ratings and the related parameters is robust. In its evaluation of controls, internal audit must consider any trade-offs made between the various mechanisms and confirm their continued appropriateness and relevance. As part of its review of control mechanisms, audit will evaluate the depth, scope, and quality of RSR's work and will conduct limited testing to ensure that their conclusions are well founded. The amount of testing will depend on whether audit is the primary or secondary reviewer of that work.

Internal audit will report to the board and management on whether the bank is in compliance with the IRB standards. This report will allow the board and management to disclose that its rating processes and the controls surrounding these processes are in compliance with the IRB standards. This will be critical for public disclosure and ongoing work of supervisors.

#### External Audit

As part of the process of certifying financial statements, external auditors will confirm that the institution's capital position is fairly presented. To verify that actual capital exceeds regulatory minimums and to confirm compliance with the IRB rules, the external auditors must ascertain that the IRB system is rating credit risk appropriately and linking these ratings to appropriate estimates. Auditors must evaluate the bank's internal control functions and its compliance with the risk-based capital regulation and supervisory guidance.

#### H. Corporate Oversight

S. The full board or a committee of the board must approve key elements of the IRB system.

Consistent with sound practice, bank management must ensure that a corporate culture exists in which institutional needs are readily identified and appropriate resources are brought to bear to rectify shortcomings. In the IRB context, senior management and the board of directors must ensure the objectivity and accuracy of the bank's credit-risk management systems and approach.

Either the full board or a committee of the board should approve key elements of the risk-rating system. Information provided to the board should be sufficiently detailed to allow directors to confirm the continuing appropriateness of the institution's rating approach and to verify the adequacy of the controls supporting the rating system.

S. Senior management must ensure that all components of the IRB system, including controls, are functioning as intended and comply with the risk-based capital regulation and supervisory guidance.

Senior management's oversight should be even more active than that of the board of directors. Senior management should articulate what it expects of the technical and operational units of the risk-rating system, as well as what it expects of the units that manage the system's controls. To oversee the risk-rating system, senior management must have an extensive understanding of credit policies, underwriting standards, lending practices, and collection and recovery practices, and must be able to understand how these factors affect default and loss estimates. Senior management should not only oversee the controls process (its traditional role) but also should periodically meet with raters and validators to discuss the rating system's performance, areas needing improvement, and the status of efforts to improve previously identified deficiencies.

The depth and frequency of information provided to the board and senior management must be commensurate with their oversight responsibilities and the condition of the institution. These reports should include the following information:

- Risk profile by grade,
- Risk rating migration across grades with emphasis on unexpected results,
- Changes in parameter estimates by grade,
- Comparison of realized PD, LGD, and EAD rates against expectations,
- Reports measuring changes in regulatory and economic capital,
- Results of capital stress testing, and
- Reports generated by rating system review, audit, and other control units.

Although all of an institution's controls must function smoothly, independently, and in concert with the others, the direction and oversight provided by the board and senior management are perhaps most important to ensure that the IRB system is functioning properly.

### Document 2: Draft Supervisory Guidance on Operational Risk Advanced Measurement Approaches for Regulatory Capital

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