Chapter 4

Credit risk

4

4.3 Guidance on internal ratings based approach: high level material

4.3.1 G Responsibility for ensuring that internal models are appropriately conservative and that approaches are compliant with the *EU CRR* rests with the *firm* itself.

4.3.2 G A *significant IFPRU firm* should consider developing internal credit risk assessment capacity and to increase use of the internal ratings based approach for calculating *own funds requirements* for credit risk where its *exposures* are material in absolute terms and where it has at the same time a large number of material counterparties. This provision is without prejudice to the fulfilment of criteria laid down in Part Three, Title I, Chapter 3, Section 1 of the *EU CRR* (IRB approach).

[**Note**: article 77(1) of *CRD*]

4.3.3 G The *FCA* will, taking into account the nature, scale and complexity of a *firm's* activities, monitor that it does not solely or mechanistically rely on external credit ratings for assessing the creditworthiness of an entity or *financial instrument*.

[**Note**: article 77(2) of *CRD*]

Application of requirements to EEA groups applying the IRB approach on a unified basis

4.3.4 G Article 20(6) of the *EU CRR* states that, where the IRB approach is used on a unified basis by those entities which fall within the scope of article 20(6) (EEA group), the *FCA* is required to permit certain IRB requirements to be met on a collective basis by members of that group. In particular, the *FCA* considers that, where a *firm* is reliant upon a rating system or data provided by another member of its group, it will not meet the condition that it is using the IRB approach on a unified basis unless:

(1) the *firm* only does so to the extent that it is appropriate, given the nature and scale of the *firm's* business and portfolios and the *firm's* position within the group;

(2) the integrity of the *firm's* systems and controls is not adversely affected;

(3) the outsourcing of these functions meets the requirements of *SYSC*; and

(4) the abilities of the *FCA* and the *consolidating supervisor* of the group to carry out their responsibilities under the *EU CRR* are not adversely affected.

4.3.5 G Prior to reliance being placed by a *firm* on a rating system or data provided by another member of the group, the *FCA* expects the proposed arrangements to have been explicitly considered, and found to be appropriate, by the *governing body* of the *firm*.

4.3.6 G If a *firm* uses a rating system or data provided by another group member, the *FCA* would expect the *firm's governing body* to delegate those functions formally to the persons or bodies that are to carry them out.

Materiality of non-compliance

4.3.7 G Where a *firm* seeks to demonstrate to the *FCA* that the effect of its non-compliance with the requirements of Part Three, Title II Chapter 3 of the *EU CRR* (Internal ratings based approach) is immaterial under article 146(b) of the *EU CRR* (Measures to be taken where the requirements cease to be met), the *FCA* expects the *firm* to have taken into account all instances of non-compliance with the requirements of the IRB approach and to have demonstrated that the overall effect of non-compliance is immaterial.

Corporate governance

4.3.8 G (1) Where the *firm's* rating systems are used on a unified basis under article 20(6) of the *EU CRR*, the *FCA* considers that the governance requirements in article 189 of the *EU CRR* can only be met if the subsidiaries have delegated to the *governing body* or designated committee of the *EEA parent institution*, *EEA parent financial holding company* or *EEA parent mixed financial holding company* responsibility for approval of the *firm's* rating systems.

(2) The *FCA* expects an appropriate individual in a *significant-influence function* role to provide to the *FCA* on an annual basis written attestation that the rating system permissions required by the *EU CRR* have been carried out appropriately.

[**Note**: see articles 189 and 20(6) of the *EU CRR* and article 3(1)(7) of *CRD*]

Permanent partial use: policy for identifying exposures

4.3.9 G The *FCA* expects a *firm* seeking to apply the Standardised Approach on a permanent basis to certain *exposures* to have a well-documented policy explaining the basis on which *exposures* are to be selected for permanent exemption from the IRB approach. This policy should be provided to the *FCA* when the *firm* applies for permission to use the IRB approach and maintained thereafter. Where a *firm* also wishes to undertake sequential implementation, the *FCA* expects the *firm's* roll-out plan to provide for the continuing application of that policy on a consistent basis over time.

Permanent partial use: exposures to sovereigns and institutions

4.3.10 G

(1) The *FCA* may permit the exemption of *exposures* to sovereigns and *institutions* under article 150(1)(a) and (b) of the *EU CRR* respectively only if the number of material counterparties is limited and it would be unduly burdensome to implement a rating system for such counterparties.

(2) The *FCA* considers that the 'limited number of material counterparties' test is unlikely to be met if for the UK group total outstandings to 'higher risk' sovereigns and institutions exceed either £1bn or 5% of total assets (other than for temporary fluctuations above these levels). For these purposes, 'higher risk' sovereigns and *institutions* are considered to be those that are unrated or carry ratings of BBB+ (or equivalent) or lower. In determining whether to grant this exemption, the *FCA* will also consider whether a *firm* incurs *exposures* to 'higher risk' counterparties which are below the levels set out but are outside the scope of its core activities.

(3) In respect of the 'unduly burdensome' condition, the *FCA* considers that an adequate, but not perfect, proxy for the likely level of expertise available to a *firm* is whether its group has a *trading book*. Accordingly, if a *firm's* group does not have a *trading book*, the *FCA* is likely to accept the argument that it would be unduly burdensome to implement a rating system.

Permanent partial use: non-significant business units and immaterial exposure classes and types

4.3.11 G

Where a *firm* wishes permanently to apply the Standardised Approach to certain business units on the grounds that they are non-significant and/or certain *exposure* classes or types of *exposures* on the grounds that they are immaterial in terms of size and perceived risk profile, the *FCA* expects to permit a *firm* to make use of this exemption only to the extent that the risk-weighted exposure amount calculated under article 92(3)(a) and (f) of the *EU CRR* that are based on the Standardised Approach (insofar as they are attributable to the *exposures* to which the Standardised Approach is permanently applied) would be no more than 15% of the risk-weighted exposure amount calculated under article 92(3)(a) and (f) of the *EU CRR*, based on whichever of the Standardised Approach and the IRB Approach would apply to the *exposures* at the time when the calculation is being made.

4.3.12 G

The following points set out the level at which the *FCA* expects the 15% test to applied for a *firm* that is a member of a *group*:

(1) if a *firm* is part of a group subject to consolidated supervision in the *EEA* and for which the *FCA* is the *consolidating supervisor*, the calculations in (1) are carried out with respect to the wider *group*;

(2) if a *firm* is part of a group subject to consolidated supervision in the *EEA* and for which the *FCA* is not the *consolidating supervisor* the calculation in (1) would not apply but the requirements of the *consolidating supervisor* relating to materiality will need to be met for the wider *group*;

(3) if the *firm* is part of a sub-group subject to consolidated supervision in the *EEA* and part of a wider third-country group subject to equivalent supervision by a regulatory authority outside of the *EEA*, the calculation in (1) would not apply but the requirements of the consolidating or lead regulator relating to materiality would need to be met for both the sub-group and the wider *group*; and

(4) if the *firm* is part of a sub-group subject to consolidated supervision in the *EEA* and is part of a wider third-country group that is not subject to equivalent supervision by a regulatory authority outside of the *EEA*, then the calculation in (1) would apply for the wider *group* if supervision by analogy is applied and for the sub-group if other alternative supervisory techniques are applied.

4.3.13 G Whether a third-country group is subject to equivalent supervision, whether it is subject to supervision by analogy or whether other alternative supervisory techniques apply, is decided in accordance with article 127 of *CRD* (Assessment of equivalence of third countries' consolidated supervision). (See article 150(1)(c) of the *EU CRR*.)

Permanent partial use: identification of connected counterparties

4.3.14 G Where a *firm* wishes to permanently apply the Standardised Approach to *exposures* to connected counterparties in accordance with article 150(1)(e) of the *EU CRR*, the *FCA* would normally expect to grant permission to do so only if the *firm* had a policy that provided for the identification of connected counterparties *exposures* that would be permanently exempted from the IRB approach and also identified connected counterparty *exposures* (if any) that would not be permanently exempted from the IRB approach. The *FCA* expects a *firm* to use the IRB approach either for all of its intra-group *exposures* or none of them (see article 150(1)(e) of the *EU CRR*).

Sequential implementation following significant acquisition

4.3.15 G In the event that a *firm* with IRB permission acquires a significant new business, it should discuss with the *FCA* whether sequential roll-out of the *firm's* IRB approach to these *exposures* would be appropriate. In addition, the *FCA* would expect to review any existing time period and conditions for sequential roll-out and determine whether these remain appropriate (see article 148 of the *EU CRR*).

Classification of retail exposures: qualifying revolving retail exposures (QRRE)

4.3.16 G (1) Article 154(4)(d) of the *EU CRR* (Risk-weighted exposure amounts for retail exposures) specifies that, for an *exposure* to be treated as a qualifying revolving retail *exposure* (QRRE), it needs to exhibit relatively low volatility of loss rates. A *firm* should assess the volatility of loss rates for the QRRE portfolio relative to the volatilities of loss rates of other relevant types of retail *exposures* for these purposes. Low volatility should be demonstrated by reference to data on the mean and standard deviation of loss rates over a time period that can be regarded as representative of the long-run performance of the portfolios concerned.

(2) Article 154(4)(e) of the *EU CRR* specifies that, for an *exposure* to be treated as a QRRE, this treatment should be consistent with the underlying risk characteristic of the sub-portfolio. The *FCA* considers that a sub-portfolio consisting of credit card or overdraft obligations will usually meet this condition and that it is unlikely that any other type of retail *exposure* will do so. If a *firm* wishes to apply the treatment in article 154 (4) of the *EU CRR* to product types other than credit card or overdraft obligations, the *FCA* expects it to discuss this with the *FCA* before doing so.

Documentation

4.3.17 G The *FCA* expects a *firm* to ensure that all documentation relating to its rating systems (including any documentation referenced in this chapter or required by the *EU CRR* that relate to the IRB approach) is stored, arranged and indexed in such a way that it could make them all, or any subset thereof, available to the *FCA* immediately on demand or within a short time thereafter.