The new "Minimum requirements for the credit business of credit institutions" and Basel II

In September 2000 the Basel Committee on Banking Supervision published its "Principles for the Management of Credit Risk", which identified concentrations of risk and weaknesses in lending and loan monitoring processes in credit institutions as the most frequent causes of problems in credit business. This is confirmed by the recent difficulties being faced by individual credit institutions.

On 20 December 2002 the Federal Financial Supervisory Authority, or FFSA (Bundesanstalt für Finanzdienstleistungsaufsicht, BaFin), published a set of "Minimum requirements for the credit business of credit institutions",[1] which define qualitative standards for organising credit business.

The new international capital adequacy requirements (Basel II), which will probably enter into effect at the end of 2006, likewise contain qualitative rules for the credit business of those institutions which use internal rating methods for measuring credit risk. The "Minimum requirements" and the lending rules under Basel II are largely congruent with one another.

Both sets of rules are ultimately designed to contribute to the soundness of credit institutions and thus also to promoting the functional ability and the stability of the German banking system.

1 In German: *Mindestanforderungen an das Kreditgeschäft der Kreditinstitute*, or *MaK;* hereinafter referred to as "Minimum requirements".

Scope of application and main features of the "Minimum requirements"

Regulatory motives

The "Minimum requirements" represent a step towards qualitative banking supervision since supervisors are now paying greater attention to credit risk management besides other factors such as the institutions' capital base and their compliance with the rules governing the disclosure of the borrower's financial situation, rules governing loans to managers and the like, and large exposure limits. In this regard the "Minimum requirements" complement the "Minimum requirements for the trading activities of credit institutions"[2] which were published back in October 1995 and the "Minimum requirements for the internal audit function of credit institutions"[3] published in January 2000.

The "Minimum requirements" mirror the best practices of well-managed credit institutions regarding the organisation of credit business. A key aim was to create a set of practical minimum requirements that are also compatible with the limited resources available to smaller banks.

Entry into force and transitional arrangements

The new "Minimum requirements" entered into force with the publication of circular 34/2002 (BA). At the same time, credit institutions have been given until 30 June 2004 to implement these requirements (first stage of implementation). Necessary adjustments in the IT area have to be implemented in a second step by 31 December 2005.

Legal basis and scope of application of the "Minimum requirements"

With its circular on the "Minimum requirements", the FFSA has given concrete shape in respect of credit business to the provisions of section 25a (1) of the Banking Act, according to which credit institutions are subject to special requirements regarding a proper business organisation, risk controlling and the monitoring of their banking business.

The "Minimum requirements" apply to all credit institutions in Germany, including branches located abroad. They do not apply to branches of enterprises domiciled in another country of the European Economic Area pursuant to section 53b of the Banking Act. In principle, all exposures within the meaning of section 19 (1) of the Banking Act (asset items and off-balance-sheet transactions entailing a counterparty risk) and all transactions with country risk fall within the scope of application of this circular. The requirements of this circular apply by analogy to trading activities, in accordance with the "Minimum requirements for the trading activities of credit institutions", as well as to participating interests. By selecting the extended credit definition of section 19 (1), the "Minimum requirements" are consistent with the definition of credit risk usually applied internationally for regulatory purposes.

Framework conditions for credit business

Banking supervisors place special emphasis on creating a proper credit risk environment within which credit business activities can develop. Credit institutions are therefore required to impose their own framework conditions for ensuring a proper and suitable or-

2 In German: *Mindestanforderungen an das Betreiben von Handelsgeschäften der Kreditinstitute,* or *MaH.*
3 In German: *Mindestanforderungen an die Ausgestaltung der Internen Revision der Kreditinstitute,* or *MaIR.*

ganisation of credit business and for creating procedures to identify, manage and monitor credit risk as well as to implement them internally. The framework conditions are to be defined for each specific institution and should take account of each institution's individual situation such as size, complexity, the focus of its operations and its ability to sustain risk.

One example of such framework conditions is the formulation of a credit risk strategy which defines lending activities over an adequate planning period. This strategy should be formulated taking into account the institution's ability to bear risk, an analysis of the business policy status quo and an estimate of the risks associated with the credit business. Internal organisational guidelines are another part of this framework. The "Minimum requirements" list areas which expressly need to be regulated by the institution, such as

– the allocation of tasks, the assignment of competencies and monitoring;

– the procedure for the timely risk assessment of the exposures, also in respect of any risk provisioning measures that might be necessary;

– risk classification procedures for assessing counterparty risk and, as appropriate, object/project risk;

– procedures for the early identification, management and monitoring of risks arising from credit business; and

– a procedure for the introduction of new types of products and the commencement of business activities on new markets.

Scope of application of the Minimum requirements for the credit business of credit institutions

Credit institutions
– within the meaning of section 1 (1) of the Banking Act (including branches of German credit institutions domiciled abroad)
– within the meaning of section 53 (1) of the Banking Act

Exposures
– within the meaning of section 19 (1) of the Banking Act (asset items and off-balance-sheet transactions entailing a counterparty risk)
– all transactions with country risk

Credit decisions:
All decisions on
– new loans
– overdrafts
– loan increases
– extensions
– changes in risk-relevant circumstances on which the lending decision was based
– definition of borrower-specific limits (including counterparty and issuer-related limits)
– participating interests

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The framework conditions have to be reviewed annually and amended as appropriate; they have to be documented logically and communicated within the credit institution.

Overall responsibility of management

By emphasising the overall responsibility of management, the "Minimum requirements" make it clear that, despite the division of managerial responsibilities prevalent in today's business world, all managers, regardless of the internal assignment of competencies, are collectively responsible for ensuring the orderly organisation of credit business and the proper management and monitoring of risks. Here the "Minimum requirements" pick up where the "Minimum requirements for the trading activities of credit institutions" and the "Minimum requirements for the internal audit function of credit institutions" left off.

Staff qualifications

The requirements concerning sufficient qualification of the staff who perform credit business relate not only to the staff active in lending decisions but to all staff involved in the various processes of the credit business chain. Adequate professional qualifications of the persons incurring, managing and monitoring the risks are of key importance. These requirements should be met by the careful selection of staff and by means of employee training measures.

Separation of functions

The rules governing the separation of functions in credit business are a core element of the "Minimum requirements". The key principle for organising the processes in credit business is the clear separation of the "front office" and "back office" functions, with the former defined as the area which initiates transactions. The separation of the two functions is to be observed all the way up to and including management level and also at deputy level (for exceptions see the section "Simplified rules" below).

The credit risk controlling function, which is responsible for independently monitoring portfolio risks and filing reports, is to be exercised by a unit not affiliated with the front office. The same applies to the units responsible for the development and quality of credit business processes and for the development, quality and monitoring of the implementation of risk classification procedures.

The involvement in the credit decision of a unit independent of the initiators of the transaction is a key element of the rules governing the separation of functions. The establishment of a credit risk controlling unit not affiliated with the front office is designed to increase the transparency of credit decisions and their effects and thereby to eliminate weaknesses in the identification of credit risk and in credit risk management which in some cases still exist.

Votes in a lending decision

Another key requirement, in keeping with the separation of the front office and back office functions, is that each credit decision necessitates a vote by a unit independent of the front office as well as by the front office. The vote of the back office is the deciding factor. This should also be reflected in the assignment of competencies and, in the case of a split vote, the subsequent escalation procedure (referral of the decision to the next higher level). The thinking behind the introduction of a two-vote rule was again to enhance the transparency of the credit transaction processes.

A different situation applies where one manager of an institution takes a credit decision within the defined scope of his individual decision-making authority. In that case the votes of the front office and back office may deviate from the manager's credit decision. These decisions, however, should be made transparent in the risk report.

Simplified rules for low-risk business

For lending decisions relating to certain types of business or for lending transactions below certain thresholds which are to be defined under risk aspects (low-risk transactions), management may decide that only one vote is necessary. To that extent the organisational separation between front office and back office is only relevant to credit transactions in which the risk involved makes two votes necessary.

Risk classification procedures and early warning procedures

Banks need to develop internal procedures for classifying their credit positions by riskiness. It is up to the banks to determine the precise design of their risk classification procedures. Meaningful and logical risk classification procedures for the initial, regular or ad hoc assessment of counterparty risk and, as appropriate, object/project risk must be established.

In addition, credit institutions have to set up early warning procedures which detect any deterioration in a borrower's creditworthiness at an early stage and enable the credit institution to take timely suitable measures to deal with the exposures in question. Such early warning procedures might include, for instance, the ongoing monitoring of current accounts. If, for example, a borrower's incoming payments deviate sharply from the usual chronological pattern, this would be an early warning indicator. Early warning procedures and risk classification procedures may be integrated in an overall risk system.

Identifying, managing and monitoring credit risk

On the basis of the risk classification procedure, banks need to implement procedures to identify, manage and monitor credit risk. As part of the requested procedures, the "Minimum requirements" additionally prescribe a regular (at least quarterly) risk report. Management must then forward the report to the supervisory board. Regulators attach great importance to this report because, without a meaningful internal reporting procedure, management cannot assume its overall responsibility for the institution, especially for assessing the risk situation. The risk report should *inter alia* comment on the development of the loan portfolio, the volume and trend of new business, the development of risk provisioning or important credit decisions which deviate from the credit risk strategy.

Minimum requirements for internal rating systems under Basel II

Internal rating methods recognised by regulators

The new Basel Capital Accord introduces qualitative and quantitative minimum requirements for banks' internal rating systems where these are required for measuring regulatory capital. Two internal ratings-based approaches (IRB approaches) exist, each of which requires approval. In addition, there is a regulatory Basel standardised approach for measuring the necessary regulatory capital for those credit institutions which do not use internal rating systems or whose internal rating systems have not been approved by regulators.

If the IRB approaches are used, the probability of default (PD), loss given default (LGD) and exposure at default (EAD), as well as the maturity, are estimated for every loan on the basis of the ratings. The regulatory capital re-

Credit risk measurement approaches under Basel II

Method	Revised standardised approach	Foundation IRB approach	Advanced IRB approach
Rating	external	internal	internal
PD estimate 1	none	own estimate	own estimate
EAD estimate 2	none	defined by the supervisor	own estimate
LGD estimate 3	none	defined by the supervisor	own estimate
Maturity	not recognised	not explicitly recognised	defined by the supervisor
Application of risk-mitigating techniques for collateral and product characteristics	defined by the supervisor	defined by the supervisor (via LGD and EAD)	own estimate (via LGD and EAD)

1 PD: Probability of Default. — **2** EAD: Exposure at Default. — **3** LGD: Loss Given Default.

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quirement is calculated from these risk parameters and on the basis of a regulatory risk weighting function. The above table illustrates the evolutionary character of the new Basel approaches to measuring credit risk.

To be approved by regulators, internal rating systems need to meet the following basic criteria. These criteria, like the "Minimum requirements", are geared closely to current best practices for rating systems in the banking industry.

Structure of rating systems

The goal of internal rating systems is to achieve a meaningful differentiation of risks within the institution's loan portfolio. Internal rating systems should also provide clues regarding major risk drivers. Internal rating systems must therefore analyse, in two separate dimensions, borrowers' creditworthiness and any collateral (two-dimensional rating system). In addition, internal rating systems should contain at least seven rating classes for non-defaulted loans and at least one rating class for defaulted borrowers. Rating systems should assess all important credit risks, but specific risk factors are not prescribed in detail. This therefore gives credit institutions extensive methodological leeway.

Rating process

The rating process should ensure the objectivity and independence of the processes of assigning credit ratings and monitoring the rating system. In practice, this can be achieved either by assigning the rating process to a unit independent of the initiators of transactions, or by fully automated and objective rating systems which leave the customer account staff no discretion to influence the rating result. The rating classification prescribed by the system can be changed at any time; however, changes must always be documented.

For methodological reasons it is additionally necessary for every borrower in an IRB portfolio to have a rating, and thus a PD, which is needed to calculate the required amount of regulatory capital. A further key requirement is that all borrowers be re-rated at least once a year to capture the current risk situation.

Corporate governance

The corporate governance rules encompass *inter alia* management's overall responsibility for the adequacy of rating systems and their correct use in internal borrower evaluation and risk management. Banks are also required to allow internal and external auditors to regularly audit the quality of rating systems and the adequacy of their use.

Banks' internal use of rating systems

If a bank has its own ratings, they must form an integral part of its internal management. Examples range from ratings-based lending decisions, assignments of competencies, limit systems and risk provisioning measures to credit risk-dependent remuneration systems. Rating systems conceived merely for regulatory purposes which are not simultaneously being used for internal risk management will not be approved.

The internal use of ratings is of key importance from a regulatory perspective. For one thing, it helps to improve internal risk management, thus promoting the stability of the banking industry. For another, credit institutions, by using these ratings in their lending decisions, have a vested interest in the rating assessments being adequate and in the attendant intensive internal monitoring. The internal use of ratings for credit risk management thus also contributes to ensuring the adequacy of PD, LGD and EAD as risk parameters.

Stress tests

To obtain a comprehensive picture of the risk situation in credit business, internal stress tests based on ratings must be performed. The idea is to use these stress tests to help banks better understand the impact of negative conjunctural influences on their loan portfolios and to take the relevant precautionary measures on that basis.

Risk quantification

Banks are required to use the uniform regulatory definition of default shown in the box on page 52 for quantifying the risk parameters PD, LGD and EAD. The uniformity of the definition of default is intended to ensure the comparability of the internally measured risk parameters. This uniformity is significant both for regulatory and for competitive reasons.

The forecast PD, LGD and EAD should, in addition, be calculated based on each banks' own internal loss history to ensure the adequacy of the risk parameters for that credit institution's specific portfolio and the rating system being used. If the bank's own loss history is not sufficient to estimate statistically

Basel definition of default

A default is considered to have occurred with regard to a particular obligor when either or both of the two following events has taken place.

- The bank considers that the obligor is unlikely to pay its credit obligations to the banking group in full, without recourse by the bank to actions such as realising security (if held).
- The obligor is past due more than 90 days on any material credit obligation to the banking group. Overdrafts will be considered as being past due once the customer has breached an advised limit or been advised of a limit smaller than current outstandings.

The elements to be taken as indications of unlikeliness to pay include:

- The bank puts the credit obligation on non-accrued status.
- The bank makes a charge-off or account-specific provision resulting from a significant perceived decline in credit quality subsequent to the bank taking on the exposure.
- The bank sells the credit obligation at a material credit-related economic loss.
- The bank consents to a distressed restructuring of the credit obligation where this is likely to result in a diminished financial obligation caused by the material forgiveness, or postponement, of principal, interest or (where relevant) fees.
- The bank has filed for the obligor's bankruptcy or a similar order in respect of the obligor's credit obligation to the banking group.
- The obligor has sought or been placed in bankruptcy or similar protection where this would avoid or delay repayment of the credit obligation to the banking group.

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valid risk parameters,[4] external or pooled data may also be used.[5]

Recognition of eligible collateral by regulators

In order to allow the risk-mitigating effect of the financial and physical collateral recognised in the IRB foundation approach to be included in the calculation of the capital charge via regulatory LGD, banks must demonstrate that the collateral they have collected is of lasting value (eg by producing expert opinions to that effect). In addition, the bank's internal collateral management system must ensure the legal enforceability and a regular realistic valuation of the collateral.

Validation of rating systems

Credit institutions which wish to use one of the IRB approaches must review the adequacy of their rating systems and risk parameters at least once a year. The banks will test the ability of rating systems to discriminate between high-quality and low-quality borrowers – if only out of self-interest. From a regulatory perspective, however, the absolute level of PD, LGD and EAD is even more important since they determine the amount of regulatory capital.

Only one empirical default rate can be calculated per rating class per year – as the quo-

4 This may be the case, for instance, if no defaults exist in the very good rating classes or even in entire portfolios, or if smaller banks generally do not have enough defaults per year and rating class for statistical analyses.
5 In this connection, pooled data refer to the estimation of PD by pooling the loss histories of several credit institutions which use comparable internal rating systems. The internal data form at least part of the data pool used for the estimates. By contrast, external data denote a default data pool containing no data from the credit institution whatsoever. A textbook example of the latter is the mapping of internal ratings to the rating scales of external rating agencies such as Standard & Poor's or Moody's and the use of their default rates.

tient of the number of borrowers defaulting in the year in question divided by all borrowers in the rating class. Statistical tests which compare the forecast PDs to the actually observed annual default rates will probably have only limited informative value owing to the short empirical time series. Notwithstanding this, the Basel Committee is still working on the development of further prudential validation methods. However, even under the already proposed rules banks should still review their forecast PDs using annual default rates and adjust their forecasts for the future as appropriate.

Disclosure of rating information

Under Basel II, credit institutions seeking to qualify for one of the IRB approaches must disclose aggregated risk information (eg forecast and actual PD, LGD and EAD per rating class) in their annual accounts. These data can be used by market participants to obtain a clearer picture of the institutions' risk structure. However, information which would make it possible to infer information about individual borrowers and would therefore be problematic in terms of data protection may not be published.

The prudential character of the "Minimum requirements" and the IRB approaches under Basel II

The implementation of both the "Minimum requirements" and Basel II will improve credit institutions' credit risk management. Nevertheless, the "Minimum requirements" and the IRB approaches are fundamentally different in terms of their prudential character. Whereas the "Minimum requirements" prescribe qualitative minimum requirements for the credit business of all credit institutions, the qualitative and quantitative minimum requirements of the IRB approaches are mandatory only for those institutions which have chosen to apply IRB approaches. The IRB approaches represent a further-reaching complement to a selected aspect of the "Minimum requirements" – the risk classification procedure.

Parallels to trading book regulations

For a bank to be able to use one of the two IRB approaches to calculate its regulatory capital, it has to submit an application for supervisory review followed by an explicit approval by supervisors. In contrast, the "Minimum requirements", as best practices, are regularly monitored at all credit institutions in the course of ongoing banking supervision. The relationship between the "Minimum requirements" and the IRB approaches is in many respects similar to the relationship between the "Minimum requirements for the trading activities of credit institutions" and banks' internal models for calculating the capital charge for market risk in line with the Basel Market Risk Paper of 1997. Both the "Minimum requirements for the trading activities of credit institutions" and the "Minimum requirements for the credit business of credit institutions" provide the necessary organisational basis for the correct use of internal models and procedures.

Supervisory Review Process (SRP)

The monitoring of the "Minimum requirements for the trading activities of credit institutions" and the "Minimum requirements for the credit business of credit institutions", as

Regulatory character of general minimum requirements and of minimum requirements for internal models

Regulatory requirements	Market risk	Credit risk	Scope of application
General qualitative process and organisational requirements	Minimum requirements for the trading activities of credit institutions	Minimum requirements for the credit business of credit institutions	To be observed by all credit institutions Audited as part of the Supervisory Review Process (SRP)
Specific requirements for internal risk quantification models	Internal Value-at-Risk models for calculating market risk pursuant to Principle I	Internal rating systems for calculating credit risk pursuant to Basel II	Only upon application by the credit institution Only after supervisory examination and approval as part of the SRP Only for the calculation of regulatory capital

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well as the audits of internal market risk models and rating systems, will all merge into the Supervisory Review Process (SRP) from the end of 2006. However, the initial review of a market risk model or an internal rating system within the SRP will continue to be tantamount to an eligibility test, a test that is conducted only at the request of the credit institution.

Granting or refusal of supervisory approval

The standardised approach is to be applied until approval to use internal rating systems for determining regulatory capital is granted or if approval is refused. This means that parallels between the respective standardised approaches for market and credit risk, on the one hand, and alternative internal methods, on the other, can also be seen in respect of the supervisory procedure.

Common features shared by the "Minimum requirements" and IRB approaches

The "Minimum requirements" concentrate on principles of the functional and organisational structure and the shaping of credit business processes. The IRB approaches of Basel II, by contrast, exclusively address the issue of risk quantification and the attendant calculation of regulatory capital. They thus focus primarily on a specific sub-sector of the "Minimum requirements" – the risk classification procedure.

The "Minimum requirements" as a "side condition" of the IRB approaches

However, some aspects of the "Minimum requirements" play a role in ensuring that ratings obtained using IRB approaches are correct. Certain general minimum requirements

Standardised approaches versus internal models

Method	Market risk	Credit risk	Scope of application
Standardised method of risk measurement prescribed by the supervisor	Standardised method for calculating the capital requirements for market risk (interest rate risk, foreign exchange risk, stock market risk and commodity risk) pursuant to Principle I	Standardised method for calculating the capital requirements for credit risk pursuant to Basel II	To be observed by all credit institutions, in principle Exemption where an internal method has been recognised
Individual methods of risk measurement developed internally	Internal Value-at-Risk models for calculating market risk	Internal rating systems for calculating credit risk	Use for calculating regulatory capital only after supervisory examination and approval

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may be interpreted as a "side condition" of the IRB approaches.

The separation of functions required by the "Minimum requirements" is rather similar to the independence of the rating assignment in the IRB approaches. Parallels similarly exist between the independent monitoring of rating systems under Basel II and the fact that responsibility for the development, quality and monitoring of the application of risk classification procedures is to be independent of the front office according to the "Minimum requirements".

There is a notable link between the Basel requirement that ratings be used for internal credit risk management and the provisions of the "Minimum requirements" with respect to the identification and management of risk, the assignment of competencies, credit risk strategy, risk provisioning and the structure of the terms and conditions. All these provisions of the "Minimum requirements" should be based on the risk information provided by internal rating systems in the case of banks using IRB approaches.

Exemptions for low-risk credit business

The exemptions for low-risk credit business expressed in the "Minimum requirements" are contained in a different form in the IRB approaches. For retail banking, a typical example of low-risk business, banks are permitted to use rating methods which are simpler, standardised, more automated and thus more cost-effective. They are often called "scorings" or "score cards" in practice. It is nevertheless necessary to assess the risk for the individual borrowers in a standardised manner since less risky business, too, needs to be backed by capital. For this, within the IRB approaches it is necessary to differentiate by risk and to estimate PD, LGD and EAD.

Congruence between the "Minimum requirements" and Basel II

General process, organisation and monitoring requirements, such as the overall responsibility of management, regular reviews by the internal audit function and external auditors, and requirements for staff qualifications are nearly identical in both sets of rules. In each case the rules require the responsible units to be familiar with the internally defined framework conditions and risk measurement methods, to be able to adequately implement and monitor them, and to have the necessary qualifications.

Specific requirements for internal rating systems

In the area of risk classification, the minimum requirements for IRB systems are far more extensive than those contained in the "Minimum requirements". Unlike the IRB approaches, the "Minimum requirements" do not require the quantification of risk by estimating PD and, as appropriate, LGD and EAD. There is neither a prudential definition of default nor a minimum number of rating classes. The risk classification procedure, which complies with the "Minimum requirements", does not have to be quantitatively validated, either.

Basel II as a special case of risk classification

An internal rating conforming to Basel II is to be considered a special case in respect of the risk classification procedures stipulated in the "Minimum requirements"; all Basel II ratings will comply with the "Minimum requirements" in respect of risk classification procedures. The reverse does not apply, though; the "Minimum requirements" can be met using much simpler procedures than for ratings conforming to Basel II. The bar must be set higher for internal rating systems than for the "Minimum requirements" because the former apply only to selected banks which voluntarily choose to pursue one of the IRB approaches whereas the "Minimum requirements" apply to all banks.

However, for those banks which choose to use one of the IRB approaches, practical considerations make it appear wise to implement the risk classification procedures of the "Minimum requirements" in such a manner as to already meet the key Basel II requirements.

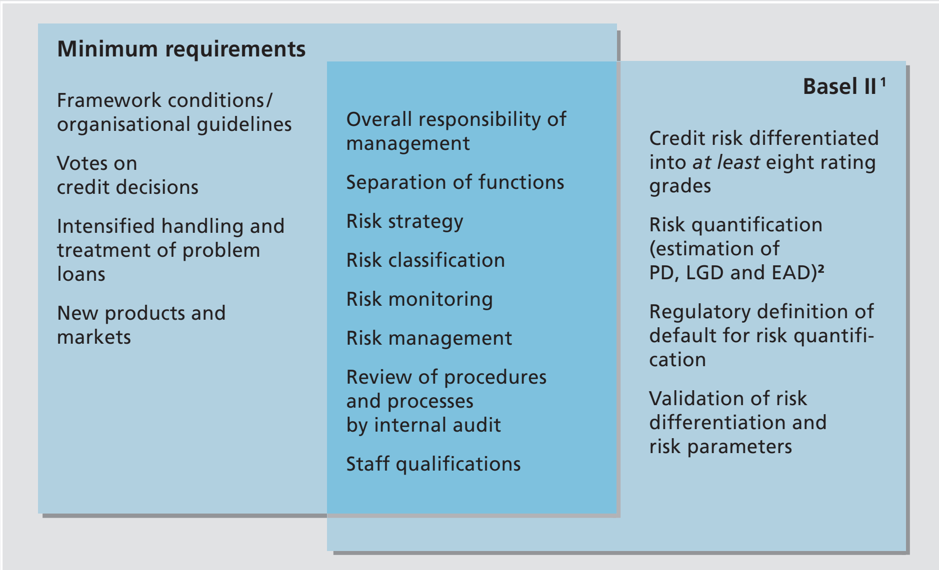
"Minimum requirements" not directly related to Basel II

Unlike the "Minimum requirements", the new Basel Capital Accord does not primarily contain specific requirements for certain internal processes such as the following.

Rules peculiar to the "Minimum requirements"

– Internal definition of the credit risk strategy and organisational guidelines for the conduct of credit business. Parts of the organisational guidelines refer to the allocation of tasks and the assignment of competencies, the structure of the processes and risk classification procedures and to the reporting procedure.

A comparison between the "minimum requirements for the credit business of credit institutions" and Basel II



1 Requirements for internal ratings under Basel II. — **2** PD: Probability of Default. EAD: Exposure at Default. LGD: Loss Given Default.

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– Voting, in the sense that credit decisions require separate votes of consent from the front office and back office.

– Rules governing the intensified handling of loans and problem loans, particularly those governing which loans are transferred to intensified handling and which are transferred to winding up or restructuring.

– The initiation of credit business in new types of products or on new markets, which must be based on the development of a strategy and, as appropriate, the subsequent conducting of a test phase.

These specific rules in the "Minimum requirements" are not essential for risk quantification and the calculation of regulatory capital. In these areas the "Minimum requirements" exceed the minimum requirements for internal ratings (for an illustration of all interdependencies between the "Minimum requirements" and the IRB approaches see the chart on this page).

"Minimum requirements" more differentiated than the Basel II standardised approach

In addition, the "Minimum requirements" are more differentiated than the Basel standardised approach in the area of risk classification. The standardised approach does not require any classification of loans using a risk classification method; only externally rated loans need to be backed by capital in a differentiated manner commensurate with the external rating. Credit institutions using the standardised approach cannot, within the context of the "Minimum requirements", rely solely on determining a differentiated level of regulatory capital by means of external ratings. An internal risk classification method which incorporates loans that are not rated externally is still necessary.