Approval for banks to use Internal Ratings Based (IRB) approaches to calculate regulatory capital requirements in Germany

The new Basel Framework is scheduled to enter into force in Germany on 1 January 2007. Institutions or groups of institutions will then be able to apply the Internal Ratings Based (IRB) approach for measuring and managing credit risk in order to calculate their regulatory capital requirements for credit risks. The Foundation IRB approach (F-IRB) may be applied from 2007; institutions may begin to use the Advanced IRB approach (A-IRB) from 2008. The use of these procedures is predicated on approval by the Federal Financial Supervisory Authority (*Bundesanstalt für Finanzdienstleistungsaufsicht* or *BaFin*), which is issued following a written application and once a supervisory examination has been successfully concluded. Credit institutions that wish to use IRB approaches for regulatory purposes can already submit an application for approval. This article describes the probable extent to which the new supervisory rules will be applied, the status of preparations for the new rules on the part of national supervisors and the financial industry, and, finally, the process by which institutions can obtain approval to use the IRB approach.

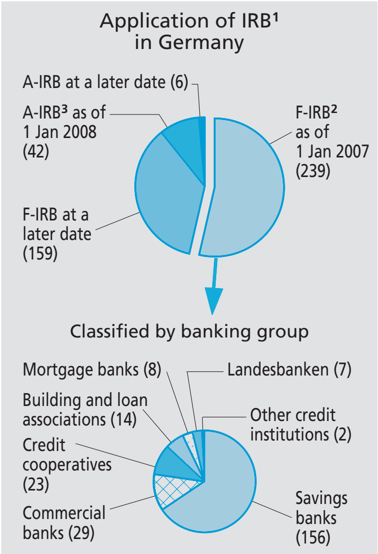
The industry's preparations

Survey on the use of the IRB approach

The aim of the negotiations on revising the current Capital Accord (Basel I) was to develop a more risk-sensitive framework for determining capital requirements. In order to ensure widespread use of the new rules among banks, convergence between banks' internal methods and supervisory methods

Survey on the implementation of Basel II

Number of institutions



1 IRB: Internal Ratings Based approach. — **2** F-IRB: Foundation IRB approach. — **3** A-IRB: Advanced IRB approach.

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was necessary. This issue led, among other things, to the development of the IRB approach, which will be a core element of the methodology for determining regulatory capital requirements. The current situation in Germany shows that the decision to develop the IRB approach was the right one, as this approach will probably be used by numerous German banks. The attendant improvement in risk management will also have a positive impact on the stability of the banking system.

Survey conducted by national supervisors in summer of 2004

In the summer of 2004, BaFin and the Bundesbank asked German credit institutions to supply information about their plans regarding methods for calculating regulatory capital requirements for credit risk and operational risk upon the implementation of Basel II. The aim of this survey was to establish how many banks will undergo licensing procedures in the next few years for the use of IRB approaches in order to plan and delegate the necessary supervisory manpower and coordinate the various audits of banking operations.

Around 40% of banks replied to the survey. The reason more banks did not reply is that many institutions are still uncertain about the implementation and planned use of the new Basel Framework. Over 40% of participating banks and savings institutions plan to apply an approved IRB approach within the next five years. Around 50 institutions indicated their intent to use the A-IRB approach in the future. As of 1 January 2007, institutions, for the first time, will be able to make use of the opportunity to use internal procedures, namely F-IRB, to calculate the regulatory capital requirement for credit risk – and, in fact, 24% of participating institutions intend to use such an IRB approach from that date on. This means that BaFin and the Bundesbank will have to conduct some 240 suitability examinations, comprising at least three rating modules for most institutions, by that time. The results of the survey on the use of IRB approaches among the various groups of institutions are presented in the chart on this page. Most of the banks are planning to include all portfolios in their IRB approaches as early as 2009 with the exception of those that are earmarked for permanent partial use. The institutions' schedules for submitting applications are therefore focused on the period from the second half of 2005 to the first quarter of 2007.

Initial assessment of the Internal Ratings Based approaches

Initial Assessments

The aforementioned survey reflects institutions' planning. In addition, BaFin and the Bundesbank have also obtained a rather comprehensive overview of the status of institutions' preparations by means of the Initial Assessments. In August 2003, supervisors offered interested institutions and associations using data pooling projects to develop rating systems the possibility of an Initial Assessment of the core rating system, ie the methodology behind their IRB systems. This assessment related to the documented structure of the rating system, its underlying data and the parameter estimations. The idea was to systematically answer queries about the suitability of concrete internal rating systems, to ensure equal treatment of all banks and, moreover, to give participating banks and associations a degree of planning certainty for the further implementation stages of their systems.

Participation and procedure

More than 20 institutions and associations submitting just over 80 core rating systems took part in the Initial Assessments. Rating systems covering each asset class were submitted. The involvement of major association and pooling projects in the German banking industry in these assessments made these findings about plans to use IRB approaches in Germany representative. The Initial Assessment campaign is scheduled for completion by the middle of this year.

The Initial Assessments were generally conducted by teams of four staff members from the Regional Offices and Central Office of the Bundesbank as well as from BaFin. Wherever possible, coherent rating systems used by the same institution or association (eg ratings for corporates, sovereigns and banks) were evaluated by the same team.

Initial Assessments as a key element of preparation for IRB approach

The Initial Assessments are a key step in preparing for the IRB approach. The supervisors' assessments give participating institutions and associations the opportunity to remedy identified shortcomings prior to the start of the licensing procedures with relatively little effort and expense. In addition, they give institutions certainty about how to interpret particular rules. At the same time, they give supervisors a well-founded and systematic overview of German banks' internal rating systems and reveal, at an early stage, the need for a consistent interpretation of individual requirements in the Basel consultative paper. The results of the Initial Assessments enabled key policy issues to be clarified within the supervisory community and in the established discussion fora with the banking industry (eg the expert panel on the IRB approach). In addition, some of the procedures and instruments applied during the Initial Assessments (eg checklists; see overview on page 11) proved their worth and will therefore be included in the IRB suitability examinations.

Outcome

On the whole, the Initial Assessments showed that nearly all participating institutions are conceptually well prepared for the IRB approach. Although many rating systems, for example, did not include enough internal data and were insufficiently documented, supervisors held that the shortcomings found were never so severe that institutions could not, with reasonable effort, remedy them by the scheduled application period. If the relevant banks implement their strategies in due time, it may be assumed that IRB approaches will be widely used in Germany from the outset.

Preparations by supervisors

National implementation of the IRB approach

"Implementation of Basel II" Working Group

In order to prepare for the national implementation of the Basel Revised Framework and the European Commission's proposals for adopting the Basel Framework at European level, in September 2003, the "Implementation of Basel II" Working Group (*Arbeitskreis Basel II*) was established under the co-chair of BaFin and the Bundesbank. The Working Group is a forum in which representatives from the supervisory community and the banking industry exchange views on aspects relating to the national implementation prior to the legal implementation of the new capital rules in Germany. In that vein, in the Working Group, BaFin and Bundesbank representatives meet with delegates from associations and institutions to discuss questions concerning the implementation of the new Framework, national discretion and issues regarding the interpretation of specific areas of regulation that arise in the course of the institutions' implementation projects. In this way, supervisors are able to address institutions' concerns without delay, thus making the implementation process more efficient overall.

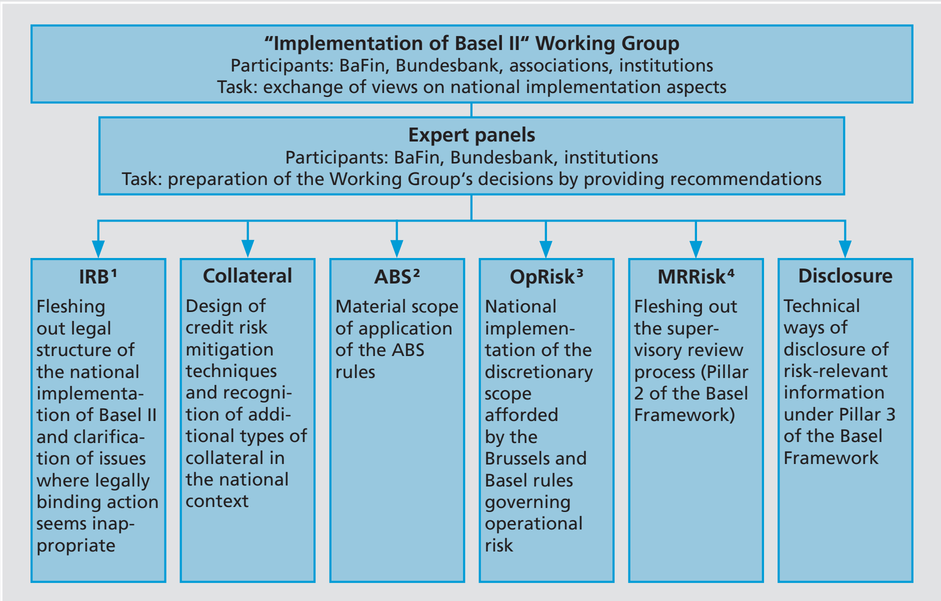
Expert panels

Six expert panels, which also consist of representatives from BaFin, the Bundesbank, banks and banking associations, report to the Working Group. In these panels, experts discuss specific aspects of the Revised Framework at a technical level and issue recommendations as preparation for the Working Group's decisions. The structure of the "Implementation of Basel II" Working Group and the tasks of its specialist sub-committees are presented in the chart on page 5.

The interpretation issues discussed in the expert panels concern, for instance, the design of the partial use of rating systems for credit risk and Advanced Measurement Approaches (AMA) for operational risk, the IRB definition of default, the national recognition of additional forms of collateral, criteria for the existence of a material transfer of risk in the securitisation rules or technical ways of disclosing risk-relevant information. The discussions are, in some cases, extremely detailed, yet this is something that is valued by the industry for the purposes of planning certainty when implementing Basel II. In order to provide the German banking industry with timely information about the current state of the discussions, the minutes and results of the Working Group and the expert panels are published on the websites of BaFin and the Bundesbank.[1]

1 http://www.bundesbank.de/bankenaufsicht/bankenaufsicht_basel_nationaleumsetzung.en.php

Preparation for the national implementation of Basel II



1 Internal Ratings Based approach. — **2** Asset-backed securities. — **3** Operational risk. — **4** Minimum requirements for risk management.

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Early involvement of the industry

By establishing the Working Group and its expert panels, the German national supervisors are embarking on new paths. This is the first time that a representative sample of delegates from associations and institutions has been actively involved in the national implementation phase of European and worldwide rules. Previously, Parliament – in cooperation with the national supervisory agencies – first drafted legislation and then presented it to the banking industry for consultation. Now, the banking industry is already involved in the development of the relevant draft and final legislative texts.

Non-decision-making bodies

The Basel II Working Group and its expert panels are not decision-making bodies, however. The actual design of the national implementation of the Basel and Brussels rules is still decided by legislators and regulators. The credit institutions’ representatives, however, have the possibility of injecting their practical expertise of banks’ internal risk management at a very early stage of the process. Banking supervisors, in turn, benefit from this experience in order to implement Basel II in a practice-oriented manner. Topics where discussions between representatives of institutions and supervisors resulted in a consensus will also be translated into national regulations along these lines. This approach will ensure the creation of a regulatory framework that is both modern and close to actual practice.

Solvency Regulation

The legal framework for applying the IRB approach will be created at the national level by translating into national law the new Basel capital rules laid down in the Revised Framework and the attendant EU Directives through an Act amending the Banking Act and a new Solvency Regulation; this Regulation will be issued by the Federal Ministry of Finance in consultation with the Bundesbank. At the end of May 2005 initial draft discussions concerning the Act amending the Banking Act (with the working title "Act on implementing the Capital Requirement Directive") and a relevant Solvency Regulation were sent to the central associations of the institutions for comment.

This Solvency Regulation will govern, among other things, the minimum requirements for the supervisory use of an IRB approach, supervisory approval to use an IRB approach, the calculation of the risk weights and the technical details concerning the quantification of risk. It will supersede the current Principle I and is scheduled to enter into force on 1 January 2007. As mentioned earlier, from that day on it will be possible to use an IRB approach for supervisory purposes.

The approval process for using the IRB approach

Preparing the future IRB approach approval procedures

Preparations by the "IRB Approach Working Group"

The IRB approach approval procedures are a core element of the implementation of the Basel and Brussels rules in Germany. They are a major challenge for banking supervisors. As early as March 2003, the task of preparing the approval procedures for the IRB approach was entrusted to a newly established BaFin/Bundesbank "IRB Approach Working Group".

Building on current supervisory rules and taking into account the results and experience obtained through the Initial Assessments, the "IRB Approach Working Group" has developed both the internal supervisory procedure for IRB approval and an application package for institutions interested in obtaining approval. This IRB application package[2] was unveiled on 22 December 2004 and contains not only templates for the documents to be submitted with the application but also an instruction sheet which describes the process of the IRB approach approval procedures and gives explanations for all documents.

Thus, since the end of 2004, BaFin and the Bundesbank have been completely prepared for accepting applications for IRB approval from interested institutions and groups and for launching the approval process. For early applications, the necessary examination process can be conducted and completed in such a timely manner that institutions will be able to obtain IRB approval by the requested date for those rating systems regarded as suitable.

Process of IRB approval examinations

Institutions and groups of institutions need BaFin approval to use the IRB approach. Ap-

2 The IRB application package can be downloaded from the websites of the Deutsche Bundesbank (www.bundesbank.de) and BaFin (www.bafin.de). The documents contained in this package will be continuously updated as further progress in European and national legislation is made.

proval may be granted only when the IRB approval procedure has given the national supervisor complete assurance that all requirements for using the IRB approach have been met.

Objective of approval procedures

Approval process

Credit institutions have the option of gradually phasing in the IRB approach (see box on page 9). They may take up to five years to completely implement the IRB approach. Supervisors expect widespread use to be made of this option, with rating systems gradually being submitted for review. The IRB approach approval process therefore spans the entire implementation period of the IRB approach at the institutions and covers the entire approval process. An approval process essentially consists of a review of the implementation plan, the monitoring of the plan during the entire implementation period, compliance with the requirements for the temporary and permanent partial use of the IRB approach and the suitability examinations of all rating systems prior to their use for calculating regulatory capital requirements.

An institution is given approval to use the IRB approach if it meets the conditions for using the IRB approach pursuant to the provisions of the Solvency Regulation and, in particular, has reached the entry threshold of 50% of assets covered by internal rating systems that have been reviewed by supervisors and deemed suitable for calculating regulatory minimum capital requirements. As the approval process progresses, suitability examinations will be carried out for those rating systems which – as envisaged by the institution's own implementation plan – will be used for the IRB approach at a later date, ie are designated for partial use. The IRB approval procedure hence covers the entire process from the submission of the application to the granting of the licence, after which only insignificant business areas may be permanently exempted from the IRB approach in accordance with the approved implementation plan.

IRB suitability examinations

A rating system includes all methods, processes, management and monitoring procedures, as well as data collection and processing systems, which support the assessment of credit risk, the assignment of exposures to rating grades or risk pools and the quantification of default and loss estimates for a certain type of exposure. Suitability examinations then determine the actual compliance with the requirements for using the IRB approach. Since a considerable percentage of the IRB requirements concern internal processes, compliance with which can be determined only at the appropriate institution itself, the suitability examinations must also take place at the institution.

The suitability examinations cover not only the minimum qualitative and quantitative requirements for IRB systems but also compliance with the implementation plan. The examinations focus on whether the portfolios are completely covered by rating systems, the extent of IRB coverage of business lines, whether the minimum capital requirement is calculated in a manner consistent with the requirements, and how IRB systems are integrated into the institution's core processes (eg credit risk management, credit standards, internal reporting). In addition, IRB suitability examinations should determine whether the preparations for compliance with the disclosure requirements for the IRB approach and the preparation of stress tests and validation procedures are sufficient to ensure complete compliance with these requirements in the future.

Close cooperation between institutions and banking supervisors

To give all interested institutions the opportunity to obtain approval to use the IRB approach to calculate their minimum capital requirements in due time, these institutions need to cooperate closely with BaFin and the Bundesbank in the light of the limited manpower available to these supervisory bodies for conducting examinations. Institutions are therefore requested to submit their applications as early as possible. These will generally be processed and examined on a first-come, first-served basis.

The IRB approach approval process

Written application

To obtain approval to use the IRB approach, a written application must be submitted to BaFin. This application may be submitted for first-time approval to use IRB, the extension of existing IRB approval to cover the internal estimation of additional risk components (loss given default (LGD), conversion factor) or the extension of existing approval to cover additional business lines, new products or new markets (if an additional rating system for which approval has not already been given is necessary).

If groups of institutions submit a consolidated application for approval to use the IRB approach, this application must state which institutions within the group are to be included in the calculation of the minimum capital requirements using the IRB approach. Furthermore, a separate application must be submitted for each institution in the group seeking approval to implement an IRB approach for calculating its individual capital requirements. If superordinated or subordinated institutions are domiciled abroad, the national supervisor will seek to coordinate the matter with the national supervisors responsible for these affiliated institutions.

Internationally active institutions

Such cross-border coordination between the relevant supervisors is necessary in order to enable internationally active banking groups, which in many cases apply identical IRB systems across national borders, to implement their IRB approaches efficiently. Since the host country supervisors are responsible for issuing approval to the individual foreign subsidiaries within a group, with Germany (as the home country) being responsible for issuing consolidated approval to use IRB, the absence of inter-agency coordination and cooperation in the process of approving these rating systems would inevitably result in unnecessary duplication of work for all parties concerned.

Close cross-border coordination of the IRB approval process also helps to harmonise the national supervisory IRB approval requirements in the various countries in which international banking groups are active, thereby ensuring a level playing field.

Entry threshold and the time which institutions have to implement the IRB approaches

In principle, the IRB approach should be applied to all of an institution's portfolios. However, under certain circumstances, the IRB approach can be temporarily or permanently waived for some types of risk-weighted assets.

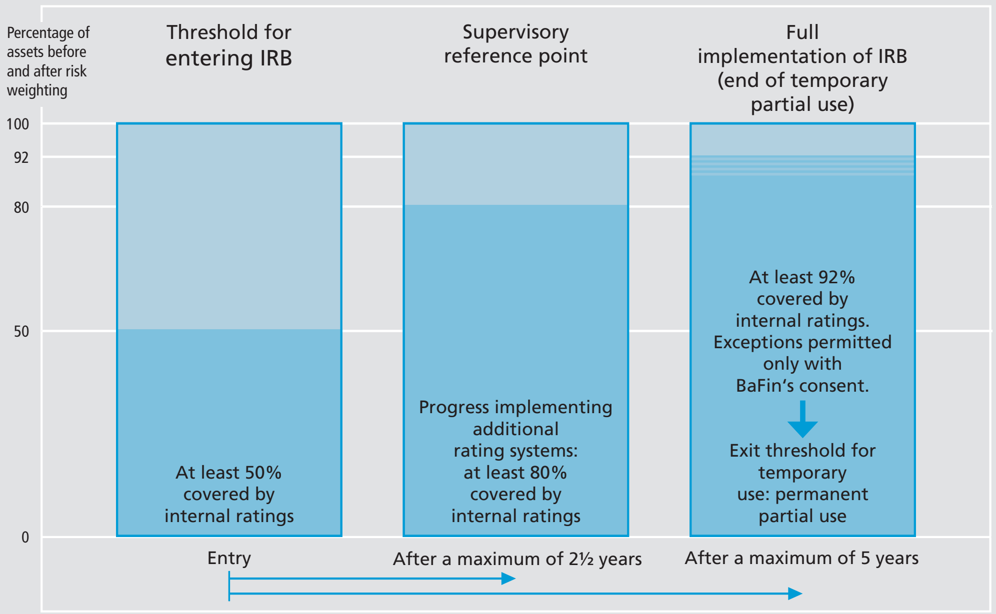
The rules for the temporary and permanent partial use of the selected IRB approach in Germany envisage at least 50% of all assets being covered by a rating system upon entry to the IRB approach both before and after risk weighting. This is called the IRB entry threshold. After at most 2½ years, the volume of assets covered by an IRB approach must have increased to 80%. The period of temporary partial use cannot last longer than 5 years after initial approval and then the requirements for permanent partial use have to be met.

Then, at least 92% of the bank's entire portfolio must be covered by an IRB approach. Exceptions are permitted only with BaFin's prior consent.

Assets for which the use of an IRB approach is not mandatory according to EU rules (permanent partial use irrespective of the materiality of the portfolio) are not governed by the limits for temporary partial use. These items for permanent partial use are as follows.

- Loans to the Federal Republic of Germany, its Federal states or municipalities (Article 89 (1) (d) of the Draft EU Directive).
- Loans to institutions and foreign sovereigns (Article 89 (1) (a) and (b) of the Draft EU Directive).
- Equity holdings/shares in the banking book.
- Securitised positions treated according to the ratings based approach (RBA).
- Risk-weighted assets of maturing business lines.
- Risk-weighted assets of existing business that is eligible for permanent partial use.

Temporary and permanent partial use of the selected IRB approach



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Application documents

The documentation that makes up a complete application for IRB approval is listed and explained in the box on page 11.

The approval process for an application begins with an assessment of the submitted implementation plan. This is followed by examinations of the suitability of the individual rating systems at the institutions. The results of these examinations are set out in a report which BaFin sends to the institutions. Moreover, the results of the examinations can be explained at a meeting, followed by coordination of the next steps in the implementation plan and the forthcoming IRB suitability examinations. At the end of the process, BaFin issues a notice declaring approval to use an IRB approach. Only after this notice of initial approval has been delivered can the applicant institution use the approved internal rating systems to calculate the minimum regulatory capital requirements. This approval may be conditional.

If only parts of the overall portfolio are covered, the initial notice does not constitute the conclusion of the IRB approval procedure. Supervisors monitor compliance with the implementation plan as well as with any conditions attached to the approval. The rating systems that are registered for the IRB approach after the entry threshold has been reached in the context of partial use can be used for the IRB approach, depending on the progress made, once supplementary approval has been obtained. If conditional approval has been issued, follow-up examinations can be required.

The rating systems are reviewed regularly for consistent appropriateness with regard to the institution's credit portfolio. The chart on page 12 shows how the entire approval process generally works.

Although the nationally legally binding implementation of the new capital rules has only just begun owing to a lack of binding EU legislation, the national supervisors have already offered to begin conducting examinations upon application by the institution prior to the entry into force of the Solvency Regulation. These examinations are ordered by BaFin pursuant to section 44 (1) sentence two of the Banking Act.

The institution submitting the application bears the costs of the approval procedure, including the costs of the examination.

Requirements to be met by the institutions in the approval process

Implementation plan

The implementation plan is crucial for a valid application for approval to use an IRB approach. The application is rejected if the implementation plan does not provide assurance that the approval process can be conducted successfully. This may be the case, for instance, if the planned duration of the transition to the IRB approach exceeds the supervisory time schedule for the IRB implementation phase or if the plan fails a plausibility test. Deviations from the submitted implementation plan must be notified to supervisors immediately.

Elements of an application for IRB approval

A complete application for the approval of an IRB approach comprises the actual application form, the implementation plan, the checklists and the descriptions of the rating systems. The **application for approval** to use an IRB approach must be submitted, along with the documentation to be enclosed, in writing and in triplicate to BaFin, which will then forward the documentation to the Bundesbank. With the exception of the descriptions, all other paperwork is to be submitted in German.

The **implementation plan** is a binding description of a bank's own implementation dates for all of the rating systems for which it is seeking approval to use the IRB approach. It thus represents the institution's plans regarding when it wants approval, for which IRB rating systems, and for which envisaged business units and sites it is seeking approval. A form is available for the implementation plan which institutions should use as a guideline.

The **checklists** are tables defined by supervisors in which the institutions concisely detail how they intend to meet the specific IRB requirements and verify this by referring to documents and to contact persons at each respective institution. A mandatory element of the paperwork to be submitted with each rating system, these checklists have to be submitted no later than along with the registration of rating systems for the suitability examination. To banks, the checklists represent a kind of quality control of the rating system prior to the examination; to the examination team, they provide a means of preparing the examination and placing the focus on certain areas in a manner commensurate with risk. They make the examination process efficient and must be completed carefully and in their entirety for each rating system by the applicant institution. A set of matching forms is provided, with instructions for completing them. Along with each checklist, institutions should also attach all documentation mentioned therein along with a list of annexes and the member banks' organisational charts.

The **descriptions** of the rating systems must be complete, well structured and of high quality. They should present, in a logical and transparent manner, the principles on which the rating system is structured, its general features, the decisions that were made when developing the rating system and how these decisions were implemented when the rating system was introduced in the bank. As long as they comply with these requirements, rating system descriptions may also be submitted by internationally active banks in English.

The checklists and all accompanying internal documentation are to be submitted in electronically readable form (eg on CD-ROM).

Supervisors reserve the right to request the submission of additional documentation if the presented paperwork does not allow, or only partly allows, supervisors to judge the suitability of rating systems. BaFin has the right to reject the application if it is not possible to examine and assess the application for approval because information is either incomplete or lacking.

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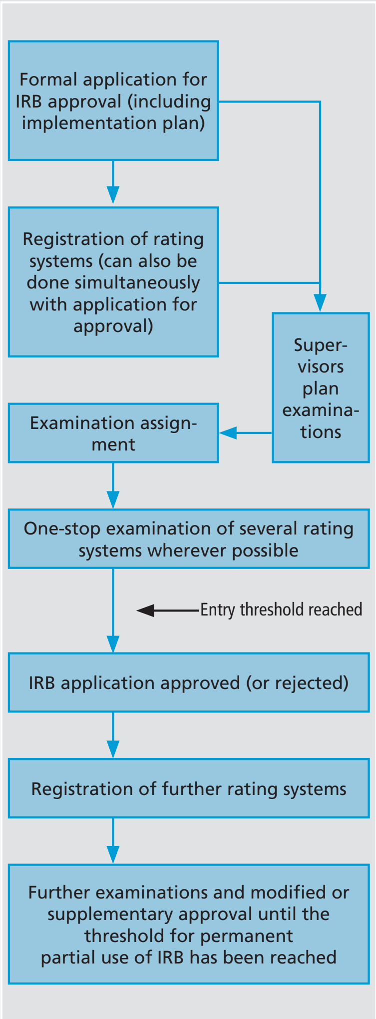
The IRB* approval process



* Internal Ratings Based approach.

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The implementation plan can be used to derive a time schedule for conducting suitability examinations. Before each suitability examination for a rating system, the bank in question has to register the system. In doing so, the institution states for which business lines and IRB asset classes it wishes to use the submitted rating system. In addition, each application for a rating system submitted by the institution must include information on how it relates to the implementation plan as well as an explanation of how the time schedule in the plan will be complied with and what degree of coverage of the entire portfolio will be achieved with the registered rating system.

Preconditions for IRB suitability examinations

A suitability examination for an IRB system makes sense only if the rating system to be reviewed has already been used successfully in day-to-day banking operations. Therefore, a rating system that is registered for an examination must have been in use as a key instrument for measuring and managing credit risk for an adequate period at the time of the examination. In addition, the institution must be sure that the rating system is a suitable instrument for credit risk measurement and management.

It is the declared aim of supervisors to minimise the time and effort for all parties concerned relating to the approval for institutions to use the IRB approach. Efficiency and cost savings in the processing of IRB applications are maximised if rating systems are not audited individually but in "sizeable bundles" that are as coherent as possible. Suitability examinations of rating systems are generally commenced only once the coverage of the entire portfolio, in the institution's estimation, has reached the threshold of 50% of all assets before and after risk weighting.

Possibility of testing individual dimensions for suitability

It will be necessary – precisely in the IRB introduction period up to 2007 – to stagger the large number of pending suitability examinations. Most institutions have also developed rating systems for retail business with a transaction-specific component (to determine LGD and the conversion factor) that is separate from the obligor-specific component (for determining PD). In this context, supervisors are willing to test, if necessary, either the obligor-specific or the transaction-specific component of the rating system separately. The suitability examination will then initially cover just that particular component. However, in such cases, the suitability of the complete rating system can be confirmed only once all components have passed the test. In individual cases, it is also conceivable to begin conducting the suitability examinations before the threshold for the partial use phase has been reached. All relevant requirements pursuant to the Solvency Regulation still have to be met by the time the rating system is being used for IRB purposes at the latest.

The IRB approval procedure thus gives banks sufficient flexibility for gradually developing and phasing in suitable rating systems.

Special features of the IRB approval process in the case of joint rating projects of the associations and banking groups

Joint rating projects of associations and banking groups

The development and use of suitable IRB systems requires considerable human and material resources. In addition, the development of internal rating systems requires a modicum of data, since an empirical basis is necessary to construct an internal rating system. In order to give small and medium-sized institutions a chance to use an IRB approach at a reasonable cost, individual associations of institutions and banking groups have initiated joint rating projects based on pooled data of the participating institutions. These pooling projects will contribute to the widespread use of the IRB approach and are lending support to the supervisors' aim of providing all interested banks with advanced methods of credit risk measurement and management.

Supervisors were early to address the issue of ways in which compliance with the minimum requirements for the IRB approach could still be ensured at the micro level when rating systems are developed in third-party pool projects (associations, banking groups etc). The development of all pool projects was supported by supervisors and evaluated during the Initial Assessments.

Although all institutions that wish to use an IRB approach have to meet the appropriate requirements completely, due account is to be taken of the features specific to jointly developed rating systems. This problem was already discussed extensively in the IRB approach expert panel early on and codified in the rating system adoption guidelines. The adoption of rating systems (adoption of databases, rating methodology, risk parameters, rating results etc) presupposes that the adopted elements of the rating system are appropriate for the adopting institution, and that it has a good understanding of the rating system's design and operation. At all events, it is necessary that, despite the adoption of a rating system, the institution's own relevant information on the obligors and transactions to be rated are fully factored into the ratings.

Each IRB system also includes a validation process that covers all aspects of the rating

Extent of institutions' own validation

system. In this review, an institution has to satisfy itself that the adopted rating elements are appropriate to the type and extent of its lending business. The institution's own data represent the framework for this validation process. Management has to recognise when adopted elements of the rating system or rating process are no longer adequate for the institution. The adopting institution must be able, at all times, to take a decision on using the adopted rating elements and to assume responsibility for this decision.

Data, information and analyses which are required for the institution's own validation process and which are the basis for deciding whether the rating system is appropriate can be provided by third parties, such as the operator of the pool.

Compliance with the IRB requirements at micro level

It follows from the IRB approach's internal logic that it can only be applied to individual institutions and that, as a result, its requirements have to be complied with at this level. It is for this reason that applications for the approval of subsystems cannot be lodged by syndicates or outsourced service units. Rather, even those institutions using rating systems developed in pool projects have to submit complete applications themselves and are subject to individual examinations. In the approval process for rating systems developed in projects, however, examiners will take account of the fact that such rating systems have elements that are virtually identical for all of the participating banks.

Initial examination at pilot banks

The envisaged approach for rating systems developed by syndicates of institutions is therefore to review such rating systems completely for compliance with all IRB requirements at a few pilot banks which are to be named in close cooperation between supervisors and the project operators. This examination covers the rating model used jointly by all pool members and its incorporation into the pilot banks. The IRB suitability examinations of related rating systems at other institutions involved in the rating project can then benefit from the experience gained during the examination of the pilot banks. In such cases, along with the review of the implementation plan, the suitability examination could be confined to the proper internal incorporation and use of the rating system. This is on the condition, however, that the insights gained during the suitability examination at the pilot institution can be equally applied elsewhere.

This multifaceted design of the requirements for adopting rating systems, along with the pilot bank strategy, is being used by supervisors to ensure that the supervisory minimum requirements for the IRB approach are also complied with by individual institutions without sacrificing the intended synergy effects. This will ensure – particularly in the case of the many institutions that belong to associations or groups – that the IRB approach can be introduced economically in the context of the implementation of the new capital rules in Germany.