Capital Requirements Directive IV Framework

*Internal Ratings Based Approach to Credit Risk in the Banking Book*

Allen & Overy Client Briefing Paper 4 | January 2014
CRD IV Framework: Internal Ratings Based Approach to Credit Risk in the Banking Book

This briefing paper is part of a series of briefings on the implementation of Basel III in Europe via the Capital Requirements Directive IV (CRD IV) and the Capital Requirements Regulation (CRR), replacing the Banking Consolidation Directive (BCD) and the Capital Adequacy Directive. The legislation is highly complex: these briefings are intended to provide a high-level overview of the architecture of the regulatory capital and liquidity framework and to draw attention to the legal issues likely to be relevant to the in-house lawyer. This briefing is for general guidance only and does not constitute definitive advice.

NOTE: In relation to the topics discussed in this briefing, CRD IV and the CRR contain a number of discretions for member states in relation to national implementation. The regime may therefore differ across member states in a number of respects.

This briefing paper is based on information available as of 17 January 2014.

Background and scope

The Internal Ratings Based approach (IRB Approach) was created as part of Basel II replacing the original Basel Accord of 1988 (Basel I) in an effort to create a better framework for regulating bank capital. Under CRD IV and the CRR, the IRB Approach is not materially changed. The basic methodology and components of the IRB Approach, as used in the non-trading book, remain consistent with that provided under the recast BCD. The relevant requirements are set out in the CRR.

Please note that this briefing paper does not cover the securitisation framework which is discussed in Client Briefing 7 (The Securitisation Framework).

Sources

CRR (Regulation 575/2013): Articles 142-191.

UK Financial Conduct Authority (FCA) Policy Statement (PS13/10) CRD IV for Investment Firms (December 2013).


PRA Supervisory Statement (SS11/13) Credit Risk: Internal Ratings Based approaches (December 2013) (the PRA Supervisory Statement on Internal Ratings Based Approaches).
Key aspects of the IRB Approach

– There remains a choice of approaches for calculating regulatory capital requirements.

– Under the IRB Approach banks and investment firms with sophisticated risk management systems may be permitted to calculate capital requirements on the basis of internally produced risk parameters subject to certain minimum requirements and agreement by the relevant member state regulator.

– The IRB Approach relies heavily upon a bank’s internal assessment of its counterparties and exposures and is consistent with the modern credit risk measurement and management practices of some sophisticated banks. It is credit risk sensitive and complex.

– The IRB Approach is intended to accurately align capital requirements with credit risk.

– Banks that adopt the IRB Approach (IRB Banks) are subject to a stringent set of minimum standards to ensure the comprehensiveness and integrity of their internal credit risk assessment capabilities. Compliance with the IRB regime requires considerable internal resources. The CRR expands the assessment criteria and approach that regulators must apply when assessing an applicant’s application to use the IRB Approach.

Post-CRR position

The IRB Approach as currently set out in the recast BCD is not materially changed in the CRR. The CRR maintains the recast BCD’s differentiation, broadly, between seven classes of exposures.

Consistent with Basel III, the CRR introduces an asset value correlation multiplier for exposures to large and unregulated financial institutions. It also makes changes to the qualitative assessment of PD for highly leveraged counterparties.

The CRR refocuses competent authorities on the monitoring of internal governance and oversight requirements. For example, in the UK, the PRA expects that one or more individuals in a Significant Influence Function will be required to annually make attestations: (a) concerning the extent of CRR compliance of a firm’s rating systems that it is permitted to use for regulatory capital purposes, (b) highlighting remediation plans to address material non-compliance, and (c) identifying aspects that the firm considers do not meet the PRA’s expectation of rating systems.
Terminology

Expected and unexpected losses

The IRB Approach is based on the concepts of expected and unexpected losses. Whereas a bank cannot predict in advance what losses it will suffer over a given period, it can forecast the average level of credit losses. Expected losses (EL) are those within the average level of reasonably foreseeable credit losses. Unexpected losses (UL) relate to other losses (ie losses above the average level of reasonably foreseeable credit losses).

To prevent insolvency, a bank must have sufficient financial resources (ie capital, provisions and write-offs) to cover the total of EL and UL. EL are generally regarded as costs of a banking business. IRB Banks must evaluate EL and factor them in when pricing their credit exposures and through provisioning and write-offs. Any shortfall between banks’ actual provisions and EL must be deducted equally from Tier 1 capital (broadly, equity) and Tier 2 capital (broadly, subordinated debt), and any excess may be included in Tier 2 capital subject to a cap. UL must be covered in capital requirements.

IRB evaluation methodologies

EL are calculated using three risk parameters: probability of default (PD), loss given default (LGD) and exposure at default (EAD) – estimated on an exposure-specific basis or, in the case of retail exposures, on a pool basis. The same risk parameters are used to calculate UL and, therefore, capital requirements. Depending upon which credit risk evaluation methodology an IRB Bank adopts, it may use its internal risk models to generate these risk parameters.

The IRB Approach offers two credit risk evaluation methodologies: the foundation IRB approach (FIRB approach) and the advanced IRB approach (AIRB approach). Under both the FIRB approach and the AIRB approach, banks provide their regulators with an internal estimate of PD. Banks that adopt the FIRB approach (FIRB banks) have the other components set by their regulators. Banks that adopt the AIRB approach (AIRB banks) calculate all of their risk parameters (PD, LGD, EAD and the effective maturity (M) of exposures) using their internal models. In providing estimates of PD, LGD, EAD and M (as applicable), an IRB Bank may rely on long-run data derived from its own experience, or from external sources, provided the bank can demonstrate the relevance of such data to its experience. In practical terms, IRB Banks will be required to develop and implement a reliable process that enables them to collect, store and utilise loss statistics over a long period of time.

PD

PD is the probability of an obligor defaulting on its contractual obligations within one year. Different banks have different approaches to defining “default”. One of the greater challenges facing IRB Banks is, therefore, to verify their historic loan performance information against the definition of “default” used by the relevant member state regulator.

Under the IRB regime, a default occurs when, broadly:

- a bank considers that the obligor is unlikely to pay its credit obligations to the banking group in full (the IRB Approach suggests certain cases where a bank may take such view); or
- the obligor’s payment is more than 90 days overdue or up to 180 days overdue (for certain exposures secured by residential or SME commercial real estate in the retail class, or
exposures to public sector entities) on any material credit obligation to the banking group.

Each estimate of PD must represent a conservative view of a long-run average PD for each obligor grade. For corporate and bank exposures, PD is subject to a floor of 0.03%. Banks must justify their PD estimates with sufficient historical experience and empirical evidence. Risk management processes and ratings upon which estimates are made will be subject to rigorous supervision and extensive recognition requirements.

**LGD and EAD**

LGD is the estimate of loss that a bank will incur if its obligor defaults. EAD is the amount the obligor owes at the time of default. In contrast with PD, LGD is a facility-specific risk parameter that takes into account specific features of the relevant transaction (e.g., collateral, subordination). It must be based on a conservative view of long-run averages. EAD is also facility specific, which in most cases will be the nominal amount of the facility. For facilities that have undrawn commitment (e.g., revolving loans), EAD will include an estimate of future lending before default. Assessment of LGD and EAD depends on the particular IRB methodology adopted.

FIRB banks must use conservative standard supervisory rules, which determine the level of LGD and EAD based upon the characteristics of the relevant transaction including the presence and type of collateral or subordination. For example, unsecured corporate, bank and sovereign exposures are assigned a 45% LGD. Subordinated claims on similar asset classes are assigned a 75% LGD.

AIRB banks determine for themselves the appropriate LGD and EAD for each exposure, but are required to do so only on the basis of robust data analysis, which is capable of being validated both internally and by the supervisory authority.

LGD and EAD assessment under the AIRB approach allows banks to take into account a wider set of transaction features (e.g., product type, collateral, etc.) as well as borrower characteristics. AIRB banks will be subject to more stringent minimum requirements in relation to the integrity and reliability of their estimates than those requirements applicable to FIRB banks.

**M**

M is the remaining economic maturity of an exposure. Determination of M also depends on the adopted IRB methodology. FIRB banks are required to assign M of 2.5 years, except for exposures arising from repo or securities lending transactions for which M of six months is assigned. AIRB banks calculate facility-specific M on the basis of prescribed formulas, subject to a one-year floor and a five-year ceiling.

**CCF**

Off-balance sheet items are treated as undrawn but committed obligations. They are evaluated as the full amount of the undrawn commitment multiplied by a credit conversion factor (CCF). As with the other risk parameters, determination of CCF depends on the adopted IRB methodology. FIRB banks use CCFs provided by their regulators. AIRB banks calculate their own CCFs.

**Reassessment of credit risks**

Given that risk parameters of an exposure fluctuate during the life of the exposure, credit risks associated with every exposure must be reassessed at least annually. Certain high risk exposures must be reassessed more frequently. Banks must devote significant internal resources to measurement and management of their credit risks throughout the life of their exposures.
Calculation of capital requirements

Capital requirements represent banks’ UL Risk weights, and thus capital requirements, are calculated using banks’ estimates of risk parameters in accordance with complex formulas prescribed by the IRB Approach. These formulas are based on modern risk management techniques that involve quantitative assessment of risk. The mechanics of calculating capital requirements vary depending on the type of exposure.

Classification of exposures

The CRR differentiates between the following classes of exposures: (1) corporates, (2) sovereigns (central governments and central banks), (3) banks, (4) retail, (5) equity, (6) securitisation, and (7) non-credit obligation assets. IRB Banks are required to assign each of their banking-book exposures to one of those classes. If an exposure does not fall within the definition of any class, it will be categorised as a corporate exposure for the purposes of the IRB Approach.

Securitisation exposures attract regulatory capital treatment under a separate securitisation-specific regime (the securitisation framework) as set out in Client Briefing 7 (The Securitisation Framework).

Corporate, bank and sovereign exposures

Capital requirements for corporate, bank and sovereign exposures are calculated by applying quantitative inputs of PD, LGD, EAD and M for each specific exposure to an IRB prescribed formula. The IRB regime offers a modified formula for exposures to small- and medium sized enterprises that have annual sales of less than €50 million.

Retail exposures

For retail exposures, the IRB Approach offers only an advanced evaluation methodology (banks without an advanced IRB Approach will be on the Standardised Approach in respect of retail exposures). Accordingly, the key parameters of PD, LGD and EAD are internally estimated by the bank. The IRB Approach distinguishes between three broad sub-categories of retail exposures, each of which provides a separate risk weight formula.

Specialised lending

Unlike other forms of corporate lending, there are several sub-categories of wholesale specialised lending, which encompass the financing of individual projects where the repayment is highly dependent on the performance of the underlying pool or collateral. For all sub-categories of specialised lending, except for high volatility commercial real estate, a bank may use the IRB Approach general framework for corporate exposures.

Where it is not possible to provide internal estimates in accordance with the IRB Approach requirements, a bank may classify a specialised lending exposure as one of five distinct quality grades, each of which carries a specific risk weight. High volatility commercial real estate is generally risky and therefore subject to separate treatment, which is more conservative than the IRB Approach general corporate framework.

Equity

The IRB Approach offers three different approaches to calculation capital requirements for equity exposures. The simple risk weight approach prescribes a set of risk weights depending on the composition of the equity portfolio:

- 190% for private equity exposures in sufficiently diversified portfolios;
- 290% for exchange traded equity exposures; and
- 370% for all other equity exposures.
Capital requirements are then calculated as a function of the applicable risk weight and the exposure value calculated in accordance with the IRB Approach rules.

The second approach is based on the PD/LGD approach for corporate exposures but subject to certain limitations. The third approach is based on a bank’s internal value-at-risk models also subject to certain limitations. Overall, the treatment of equity exposures under the IRB Approach is significantly less favourable than that used under the Standardised Approach.

Non-credit obligations and collective investment undertakings

Non-credit obligations are risk weighted on the basis of a 100% risk weight. Collective investment undertakings are risk weighted in one of two ways:

- If the bank has sufficient information on the underlying assets, then a “look through” approach is taken to risk weighting the underlying assets (subject to certain modifications); or
- If the bank does not have sufficient information on the underlying assets, it must treat the exposure in the same way as equity exposures.

Credit risk mitigation

The IRB Approach recognises the benefits of eligible credit risk mitigation (CRM) when calculating capital requirements for corporate, sovereign, bank and equity exposures. This is discussed in Client Briefing 5 (Collateral: Funded Credit Risk Mitigation in the Banking Book) and Client Briefing 6 (Unfunded Credit Risk Mitigation in the Banking Book: Guarantees and Credit Derivatives).

Asset value correlation multiplier

CRR increases risk weights on certain exposures to financial institutions. A multiplier of 1.25 is introduced into the calculation of risk weighted exposure amounts for exposures to “large financial sector entities” and “unregulated financial entities”. Both of these terms are defined in Article 142(1)(4) of CRR. A notable aspect of the “large financial sector entities” definition is that such an entity must hold total assets, calculated on an individual or consolidated basis, greater than or equal to €70 billion.
Minimum requirements for the IRB Approach

Banks may only apply the IRB Approach if they receive express permission from their regulators. Such permission may only be granted if a bank’s rating and risk management systems are sound and have been implemented with integrity and subject to the bank complying with various systems and controls and corporate governance requirements. In practice, this means that an IRB Bank must have an economic model that is appropriate for its activities, effective for risk management purposes, and which can be validated by back-testing against live data.

The CRR expands the assessment criteria that regulators must apply when assessing an applicant’s application to use the IRB Approach. Furthermore, the CRR prescribes the approach regulators must take when assessing an application to use the IRB Approach.

An applicant bank must demonstrate to the satisfaction of the relevant member state regulator that the following standards are met:

1. the bank’s rating systems provide for a meaningful assessment of obligor and transaction characteristics, a meaningful differentiation of risk, and accurate and consistent quantitative estimates of risk;
2. internal ratings and default and loss estimates used in the calculation of own funds requirements and associated systems and processes play an essential role in the risk management and decision-making process, and in the credit approval, internal capital allocation and corporate governance functions of the bank;
3. the bank has a credit risk control unit responsible for its rating systems that is appropriately independent and free from undue influence;
4. the bank collects and stores all relevant data to provide effective support to its credit risk measurement and management process;
5. the bank documents its rating systems and the rationale for their design and validates its rating systems;
6. the bank has validated each rating system and each internal models approach for equity exposures during an appropriate time period prior to the permission to use this rating system or internal models approach to equity exposures, has assessed during this time period whether the rating system or internal models approaches for equity exposures are suited to the range of application of the rating system or internal models approach for equity exposures, and has made necessary changes to these rating systems or internal models approaches for equity exposures following from its assessment;
7. the bank has calculated under the IRB Approach the own funds requirements resulting from its risk parameters estimates and is able to submit the prescribed reports; and
8. the bank has assigned and continues to assign each exposure in the range of application of a rating system to a rating grade or pool of this rating system; the bank has assigned and continues to assign each exposure in the range of application of an approach for equity exposures to this internal models approach. The requirements to use an IRB Approach, including own estimates of LGD and conversion factors, apply also where a bank has implemented a rating system, or model used within a rating system, that it has purchased from a third-party vendor.

IRB Banks remain subject to stringent operational requirements, some of which are mentioned below.
The IRB “use” test

The essential role of internal ratings in the calculation of capital requirements means that systems that a bank applies to generate internal ratings and risk parameters must be consistent with their internal use by the bank. Where there is a justifiable gap between a bank’s IRB Approach estimates and estimates used for internal purposes, the bank must demonstrate the reasonableness of that gap to its relevant member state regulator. This is known as the “use” test.

Stress testing

Banks’ gradings must take into account adverse economic conditions as well as the risk of the occurrence of unexpected events. This creates a cyclical effect whereby capital requirements for IRB Banks may increase sharply as the credit quality of their exposures deteriorates, leading to a much greater variation in capital requirements due to high sensitivity to fluctuations in the economic cycle. To mitigate the impact of cyclicality, IRB Banks are required to stress test their capital requirements in order to ensure that they have an adequate capital buffer for a “rainy day”. Specific scenarios against which banks’ models should be stress tested vary from one member state regulator to another.

EBA technical standards and guidelines

The CRR mandates that various technical standards and guidelines shall be produced. In connection with the IRB Approach, the following standards and guidelines shall be produced:

<table>
<thead>
<tr>
<th>CRR SOURCE</th>
<th>TECHNICAL STANDARDS/ GUIDELINES REQUIRED</th>
<th>DEADLINE FOR SUBMISSION TO THE EUROPEAN COMMISSION</th>
<th>EBA PUBLICATIONS</th>
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<tbody>
<tr>
<td>Article 143 (Permission to use the IRB Approach)</td>
<td>Draft regulatory technical standards (RTS) to “specify the conditions for assessing the materiality of the use of an existing rating system for other additional exposures not already covered by that rating system and changes to rating systems or internal models approaches to equity exposures under the IRB Approach.”</td>
<td>31 December 2013.</td>
<td>Consultation on the conditions for assessing the materiality of extensions and changes of internal approaches when calculating own funds requirements for credit, market and operational risk (March 2013) (EBA/CP/2013/02). Final draft regulatory technical standards on the conditions for assessing the materiality of extensions and changes of internal approaches when calculating own funds requirements for credit and operational risk in accordance with Articles 143(5) and 312(4)(b) and (c) of Regulation (EU) No</td>
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<tr>
<td>CRR SOURCE</td>
<td>TECHNICAL STANDARDS/ GUIDELINES REQUIRED</td>
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<td>Article 144 (Competent authorities' assessment of an application to use an IRB Approach)</td>
<td>Draft regulatory technical standards (RTS) to “specify the assessment methodology competent authorities shall follow in assessing the compliance of an institution with the requirements to use the IRB Approach.”</td>
<td>31 December 2014.</td>
<td>None to date.</td>
</tr>
<tr>
<td>Article 148 (Conditions for implementing the IRB Approach across different classes of exposure and business units)</td>
<td>Draft regulatory technical standards (RTS) to “specify the conditions according to which competent authorities shall determine the appropriate nature and timing of the sequential roll out of the IRB Approach across exposure classes referred to in paragraph 3.”</td>
<td>31 December 2014.</td>
<td>None to date.</td>
</tr>
<tr>
<td>Article 150(3) (Conditions for permanent partial use)</td>
<td>Draft regulatory technical standards (RTS) to “determine the conditions of application of points (a), (b) and (c) of paragraph 1.”</td>
<td>31 December 2014.</td>
<td>None to date.</td>
</tr>
<tr>
<td>Article 150(4) (Conditions for permanent partial use)</td>
<td>Guidelines on the application of point (d) of paragraph 1 in 2018, recommending limits in terms of a percentage of total balance sheet and/or risk weighted assets to be calculated in accordance with the Standardised Approach.</td>
<td>Expected 2018.</td>
<td>None to date.</td>
</tr>
<tr>
<td>Article 152(5) (Treatment of exposures in the form of shares in CIUs)</td>
<td>Draft regulatory technical standards (RTS) To “specify the conditions according to which competent authorities may permit institutions to use the Standardised Approach referred to in Article 150(1) under point (b) of paragraph 2 of this Article.”</td>
<td>30 June 2014.</td>
<td>None to date.</td>
</tr>
<tr>
<td>Article 153(9) (Risk weighted exposure amounts for exposures to corporates, institutions and central governments and central banks)</td>
<td>Draft regulatory technical standards (RTS) to “specify how institutions shall take into account the factors referred to the second subparagraph of paragraph 5</td>
<td>31 December 2014.</td>
<td>None to date.</td>
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</table>

575/2013 (Capital Requirements Regulation – CRR) (December 2013) (EBA/RTS/2013/06).
<table>
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<tr>
<th>CRR SOURCE</th>
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<tbody>
<tr>
<td>Article 164(6) (Loss Given Default (LGD))</td>
<td>Draft regulatory technical standards (RTS) to “specify conditions that competent authorities shall take into account when determining higher minimum LGD values.”</td>
<td>31 December 2014.</td>
<td>None to date.</td>
</tr>
<tr>
<td>Article 173(3) (Integrity of assignment process)</td>
<td>Draft regulatory technical standards (RTS) for “the methodologies of the competent authorities to assess the integrity of the assignment process and the regular and independent assessment of risks.”</td>
<td>31 December 2014.</td>
<td>None to date.</td>
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<tr>
<td>Article 178(6) (Default of an obligor)</td>
<td>Draft regulatory technical standards (RTS) to “specify the conditions according to which a competent authority shall set the threshold referred to in paragraph 2(d).”</td>
<td>31 December 2014.</td>
<td>None to date.</td>
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<tr>
<td>Article 178(7) (Default of an obligor)</td>
<td>Guidelines on the application of this Article.</td>
<td>Not yet specified.</td>
<td>None to date.</td>
</tr>
<tr>
<td>Article 180(3) (Requirements specific to PD estimation)</td>
<td>Draft regulatory technical standards (RTS) to “specify the following: (a) the conditions according to which competent authorities may grant the permissions referred to in point (h) of paragraph 1 and point (e) of paragraph 2; (b) the methodologies according to which competent authorities shall assess the methodology of an institution for estimating PD pursuant to Article 143.”</td>
<td>31 December 2014.</td>
<td>None to date.</td>
</tr>
<tr>
<td>Article 181(3) (Requirements specific to own-LGD estimates)</td>
<td>Draft regulatory technical standards (RTS) to “specify the following: (a) the nature, severity and duration of an economic downturn referred to in paragraph 1; (b) the conditions according to which a competent authority may permit an institution pursuant to paragraph 3 to use relevant</td>
<td>31 December 2014.</td>
<td>None to date.</td>
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</table>
The CRR mandates that the following European Commission implementing acts are produced:

<table>
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<tr>
<th>CRR SOURCE</th>
<th>EUROPEAN COMMISSION IMPLEMENTING ACTS REQUIRED</th>
<th>DEADLINE</th>
<th>EUROPEAN COMMISSION PUBLICATIONS</th>
</tr>
</thead>
<tbody>
<tr>
<td>Article 142(2) <em>(Definitions)</em></td>
<td>EC to adopt a decision by way of implementing acts as to whether a third country applies supervisory and regulatory arrangements at least equivalent to those applied in the EU.</td>
<td>1 January 2015.</td>
<td>None to date.</td>
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### National discretions and UK implementation

The CRR provides member state “competent authorities” with certain discretions:

<table>
<thead>
<tr>
<th>CRR SOURCE</th>
<th>NATURE OF DISCRETION</th>
<th>FCA/PRA APPROACH</th>
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<tr>
<td>Articles 143 (Permission to use IRB approach) and 144 (Competent authorities’ assessment of an application to use an IRB approach)</td>
<td>These articles permit a firm to use an IRB model provided that a competent authority deems the firm to have met the conditions in Part Three, Title II, and Chapter 3. The EBA will submit standards around the IRB assessment methodology by 31 December 2014.</td>
<td>In respect of FCA authorised firms, the FCA intends to exercise this discretion (see Annex 3 (List of national discretions and FCA’s approach to their application) to CP 13/6 CRD IV for Investment Firms (July 2013)). See IFPRU 4.4 (Internal ratings based approach: overall requirements for estimation) and 4.11 (Income producing real estate portfolios). In respect of PRA authorised firms, see the PRA Rulebook at Annex K (Waivers and Transitional Provisions) and the PRA Supervisory Statement on Internal Ratings Based Approaches at paragraphs 1 and 6.</td>
</tr>
<tr>
<td>Article 150 (Conditions for permanent partial use)</td>
<td>Further criteria for IRB Permission: Where institutions have received the prior permission of the competent authority, institutions permitted to use the IRB Approach in the calculation of risk-weighted exposure amounts and expected loss amounts for one or more exposure classes may apply the Standardised Approach for certain exposures.</td>
<td>In respect of FCA authorised firms, the FCA intends to exercise this discretion (see Annex 3 (List of national discretions and FCA’s approach to their application) to CP 13/6 CRD IV for Investment Firms (July 2013)). See IFPRU 4.3.10, 4.3.13 and 4.3.14. In respect of PRA authorised firms, see the PRA Supervisory Statement on Internal Ratings Based Approaches at paragraph 6.</td>
</tr>
<tr>
<td>Article 157 (Risk weighted exposure amounts for dilution risk of purchased receivables)</td>
<td>Further criteria for IRB Permission: The competent authority may exempt a firm from the obligation to calculate and recognise Risk Weight Exposure Amount (RWEA) for dilution risk where the firm has demonstrated to the competent authority that dilution risk is immaterial for a given exposure.</td>
<td>In respect of FCA authorised firms, the FCA intends to exercise this discretion (see Annex 3 (List of national discretions and FCA’s approach to their application) to CP 13/6 CRD IV for Investment Firms (July 2013)).</td>
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<tr>
<td>Article 162 (Maturity)</td>
<td>Further criteria for IRB permissions: Article 162(1) – for Foundation IRB firms, a competent authority may give a direction to a firm to use a specified Maturity for each exposure among those set out in Article 162(2). Article 162(2)(h) – The competent authority may give a firm using an internal model to calculate credit valuation adjustment (CVA) authorisation to use its own estimate of effective credit duration as maturity (M).</td>
<td>In respect of FCA authorised firms, the FCA intends to exercise this discretion (see Annex 3 (List of national discretions and FCA’s approach to their application) to CP 13/6 CRD IV for Investment Firms (July 2013)). See IFPRU 4.14.4 and 4.14.5. In respect of PRA authorised firms, see the PRA Supervisory Statement on Internal Ratings Based Approaches at paragraph 15 and the PRA Supervisory Statement on Counterparty Credit Risk at paragraph 2. See also the PRA Policy Statement at paragraphs 7.18 and 7.19.</td>
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<tr>
<td>CRR SOURCE</td>
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<td>Article 162(2)(i) – A firm, with an Internal Model Method (IMM) Permission and a specific market risk internal model permission for traded debt instruments shall set M to 1 in the formula laid out in Article 153(1), provided that the firm can demonstrate to the competent authority that its internal model for specific risk associated with traded debt positions under Article 383 contains effects of rating migrations.</td>
<td>In respect of FCA authorised firms, the FCA intends to exercise this discretion (see Annex 3 (List of national discretions and FCA’s approach to their application) to CP 13/6 CRD IV for Investment Firms (July 2013)). In respect of PRA authorised firms, see the PRA Policy Statement at paragraph 7.24.</td>
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<tr>
<td>Articles 164 (Loss given default) and 199 (Additional eligibility for collateral under the IRB approach)</td>
<td>Article 164(2) – The competent authority may decide whether unfunded credit protection is eligible in support of an individual exposure or pool of exposures. Article 164(5) – The competent authority must assess periodically and, at least, annually whether the minimum Loss Given Default (LGD) set out in paragraph (4) for exposures secured by residential and commercial real estate are appropriate. The competent authority may increase these minima on the basis of financial stability considerations.</td>
<td>In respect of FCA authorised firms, the FCA intends to exercise this discretion (see Annex 3 (List of national discretions and FCA’s approach to their application) to CP 13/6 CRD IV for Investment Firms (July 2013)). In respect of PRA authorised firms, see the PRA Supervisory Statement on Internal Ratings Based Approaches at paragraph 15.</td>
</tr>
<tr>
<td>Article 166(8) (Exposures to corporates, institutions, central governments and retail exposures)</td>
<td>Permission to use own estimates of conversion factors (Article 166(8)(e)): an advanced IRB firm may use its own estimates of conversion factors across the different product types listed in sub-paragraphs (a) to (d) of Article 166(8) with the prior consent of the competent authority.</td>
<td>In respect of FCA authorised firms, the FCA intends to exercise this discretion (see Annex 3 (List of national discretions and FCA’s approach to their application) to CP 13/6 CRD IV for Investment Firms (July 2013)). In respect of PRA authorised firms, see the PRA Supervisory Statement on Internal Ratings Based Approaches at paragraph 15.</td>
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<td>Article 170(4) (Structure rating systems)</td>
<td>A competent authority may exempt a firm from the obligation to include ‘delinquency’ as a risk driver for assigning exposures to grade or pools, provided that delinquency is not material for a given exposure.</td>
<td>In respect of FCA authorised firms, the FCA intends to exercise this discretion (see Annex 3 (List of national discretions and FCA’s approach to their application) to CP 13/6 CRD IV for Investment Firms (July 2013)). In respect of PRA authorised firms, see the PRA Supervisory Statement on Internal Ratings Based Approaches at paragraph 15.</td>
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<tr>
<td>Article 178(1)(b) (Default of an obligor)</td>
<td>CRR allows the PRA to replace 90 days in the days past due component of the definition of default with 180 days for exposures secured by residential or SME commercial real estate in the retail exposure class, and for exposures to Public Sector Entities.</td>
<td>In respect of FCA authorised firms the FCA intends to exercise this discretion (see Annex 3 (List of national discretions and FCA’s approach to their application) to CP 13/6 CRD IV for Investment Firms (July 2013)). See IFPRU 4.5 and 4.6. In respect of PRA authorised firms, the PRA proposes to define a requirement specifying that the number of days past due for the purposes of the definition of default is 90. In respect of PRA authorised firms, the PRA is consulting on allowing firms to apply for a waiver from the 90 day definition of default Public Sector Entities rating systems and retail residential</td>
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<td>CRR SOURCE</td>
<td>NATURE OF DISCRETION</td>
<td>FCA/PRA APPROACH</td>
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<td>mortgage rating systems built after 31 December 2013. See the PRA Rulebook at Annex K (Waivers and Transitional Provisions), the PRA Supervisory Statement on Internal Ratings Based Approaches at paragraphs 11 and 12 and the PRA Policy Statement at paragraphs 7.14 and 7.15.</td>
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<td>A competent authority may allow in a firm’s IRB Permission flexibility in the application of the required standards for data in relation to data collected prior to 1 January 2007. In respect of FCA authorised firms the FCA intends to exercise this discretion (see Annex 3 (List of national discretions and FCA’s approach to their application) to CP 13/6 CRD IV for Investment Firms (July 2013)). See IFPRU 4.4.8, 4.6.13, 4.6.31, 4.7.4, 4.7.6, 4.7.7, 4.7.13, 4.8.7, 4.8.16. In respect of PRA authorised firms, see the PRA Supervisory Statement on Internal Ratings Based Approaches at paragraphs 10, 12, 13 and 14.</td>
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<td>A competent authority may allow a firm in its IRB Permission to use data covering 2 years (not 5 years) for LGD and conversion factors estimations in certain circumstances, when the firm implements the IRB approach. In respect of FCA authorised firms the FCA intends to exercise this discretion (see Annex 3 (List of national discretions and FCA’s approach to their application) to CP 13/6 CRD IV for Investment Firms (July 2013)). See IFPRU 4.4.13, 4.4.15, 4.6.8, 4.6.31, 4.7.3, 4.7.9, 4.7.10, 4.7.17, 4.8.12 and 4.8.16. In respect of PRA authorised firms, see the PRA Supervisory Statement on Internal Ratings Based Approaches at paragraphs 10, 12, 13 and 14.</td>
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<td>A competent authority may allow a firm in its IRB Permission to recognise conditional guarantees as eligible for the purposes of assessing the effect of these guarantees in the firm’s calculation of own LGDs. In respect of FCA authorised firms the FCA intends to exercise this discretion (see Annex 3 (List of national discretions and FCA’s approach to their application) to CP 13/6 CRD IV for Investment Firms (July 2013)).</td>
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<td>Where specified conditions are met, the competent authority shall permit an institution to use as eligible collateral physical collateral of a type other than those listed in article 119(2-4). In respect of FCA authorised firms the FCA intends to exercise this discretion (see Annex 3 (List of national discretions and FCA’s approach to their application) to CP 13/6 CRD IV for Investment Firms (July 2013)). In respect of PRA authorised firms, see the PRA Rulebook at Annex K (Waivers and Transitional Provisions).</td>
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</table>
Further reading

Client Briefing 1 (Introduction to Regulatory Capital and Liquidity)
Client Briefing 3 (Standardized Approach to Credit Risk in the Banking Book)
Client Briefing 7 (The Securitisation Framework)
Client Briefing 11 (Trading Book)

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