RSU

Pickin` the IRBA Cherry out of the SA Basket
The New Permanent Partial Use Under The Basel IV Framework

It's been roughly three years now that the Basel Committee on Banking Supervision (BCBS) published "Basel III: Finalising post-crisis reforms" to complement the Basel Framework (BCBS 424, December 2017).

Contrary to initial concerns, the host of rules packed into the 158-page document still leaves considerable leeway to the regulated institutions.

Although a lot has been said and written about the revised standards, one particular aspect has received surprisingly little attention even though it opens up some rather interesting perspectives: the new rules on what is referred to as "partial use".

Current Regulatory Framework: Standardised Approach OR IRBA (choose one)

Even though member states have interpreted the relevant EU regulations (articles 148 to 150 of the CRR) in different ways, the principle has always been the same:

Institutions have had to decide between the IRB Approach and the Standardised Approach (SA), i.e. whether to use their own estimates or fixed parameters to determine their capital requirements. If you opt for the IRBA (further divided into the F-IRBA – PD estimates only –and the A-IRBA – PD, LGD and CCF estimates) you have to use IRB-compliant rating systems to rate most of your exposures. While there are a number of exceptions and certain floors applied, the fact remains that a fundamental choice has to be made between the IRBA and the SA.

Moreover, whereas changing from the SA to the IRBA is absolutely possible, going back is very difficult and subject to very strict conditions (see article 149 of the CRR).

This puts banks in a difficult position because introducing and maintaining rating systems for the IRBA has always been very challenging and the requirements to be met have become even stricter by now. That's why especially small and medium-sized institutions have so far stayed clear of more advanced credit risk assessment tools.

New system: Standardised Approach AND IRBA (the best of both worlds)

In this respect, BCBS 424 represents a paradigm change: it allows institutions to apply the IRBA to a part of their exposures and continue to use the SA for the rest. Granted, if you ask permission to do so in the future, supervisory authorities will check whether you can be reasonably expected to apply the IRBA to other parts of your portfolio as well. Nevertheless "permanent partial use" will no longer be limited to a few exceptions and is even explicitly provided for in the new framework.

Also new: Standardised Approach is becoming more demanding

Another – much debated – aspect of the BCBS's finalised reforms is the tightening of the rules for the SA. Although ratings from agencies will continue to play a crucial part under this approach, banks will be required to review these ratings ("Due Diligence") and will have to downgrade customers whose ratings they find too favourable.

As a result, the cost of the SA both in terms of resources and risk weights is likely to increase.

Join the pool party

Since the IRBA allows a bank to reduce its capital burden substantially for certain types of exposures and provides better risk differentiation to boot, banks may want to consider swapping the SA for the IRBA for part of their portfolio. This, however, can be very demanding as supervisory standards for rating systems used for the IRBA are tight. One key obstacle to developing reliable models is often the small number of relevant cases. While this is not usually a problem in retail banking, it may very well be in larger-scale lending. An interesting solution is mentioned in the ECB guide to internal models (October 2019): Using rating models based on pooled data from several banks. This has been done very successfully for 15 years, especially in Germany, although it is still quite uncommon in other European countries. Advantages include a considerably larger reference dataset – and cost-effective access to the IRB Approach.

A pool model is a collaborative effort involving a central service provider which develops, operates, and validates rating systems for specific asset classes (in particular non-retail exposures) and answers for them to supervisory authorities. The model is based on the exposure data of all client banks (pool), which considerably increases the amount of data available and consequently, the model's accuracy. The service provider and its client banks have separate responsibilities (providing the rating system vs. preparing the ratings). Apart from increased accuracy, pool models offer cost effectiveness and less strain on valuable quantitative resources. Especially IRBA institutions face considerable and ever-changing regulatory challenges. If a service provider can shoulder part of the burden, both banks and supervisory authorities can reap the benefits.

You'd like to learn more? Then we should meet: infos@rsu-rating.de

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As a full service provider we handle the IT implementation and operation of our systems for banks, insurance companies, and other financial institutions in both the public and private sector. Currently more than 7,000 users work with our systems.
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