



South African Reserve Bank
From the Office of
the Registrar of Banks

G4/2014

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To banks, branches of foreign institutions, controlling companies, eligible institutions and auditors of banks or controlling companies

Guidance Note 4/2014 issued in terms of section 6(5) of the Banks Act, 1990

Application process in respect of the proposed adoption of the internal ratings-based approach for the measurement of banks' credit risk exposure in respect of positions held in the banking book

Executive summary

In terms of regulation 23(10)(a) of the Regulations relating to Banks (the Regulations), banks are required to obtain the prior written approval of the Registrar of Banks to adopt the foundation internal ratings-based (IRB) approach or the advanced IRB approach (jointly referred to as the 'advanced approaches') for the measurement of their exposure to credit risk in respect of positions held in the banking book.

The purpose of this guidance note is to inform all banks, controlling companies and branches of foreign institutions (hereinafter collectively referred to as 'banks') of the process to be followed and the information required to be submitted when applying to use the advanced approaches.

This Guidance Note replaces Guidance Note 4/2010, issued 25 June 2010, and requires additional information and documentation to be included in the IRB application pack.

1. Guidance on submitting an internal ratings-based approach application

- 1.1 All banks intending to adopt the advanced approaches are required to submit a duly completed IRB application pack, attached as Annexure A. This would include the information as required in the various sections of the application pack and duly completed declarations signed by the bank's chief executive officer and chairperson of the board of directors.
- 1.2 Banks should make provision for a period of up to 18 months between submitting a completed IRB application pack and approval being granted or denied. Applicant banks will also be required, once advised by this Office, to perform a BA return reporting parallel run for a period of 6 months during the above-mentioned application period of 18 months as described in Annexure A.

2. Acknowledgement of receipt

Two additional copies of this guidance note are enclosed for use by your institution's independent auditors. The attached acknowledgement of receipt, duly completed and signed by both the chief executive officer of the institution and the said auditors, should be returned to this Office at the earliest convenience of the aforementioned signatories.



René van Wyk
Registrar of Banks

Encl. 2

The previous guidance note issued was Guidance Note 3/2014, dated 13 February 2014.

Application to adopt the internal ratings-based approach for the measurement of credit risk exposure in respect of positions held in the banking book (IRB application)

February 2014

General information on the IRB application

1. The Regulations relating to Banks (the Regulations) stipulate several approaches available to banks, controlling companies and branches of foreign institutions (hereafter referred to as 'banks') for calculating the minimum required amount of Common Equity Tier 1, Additional Tier 1 and Tier 2 capital and reserve funds relating to banks' exposure to credit risk. Banks are required to obtain the prior written approval of the Registrar of Banks to adopt the foundation IRB approach and/or the advanced IRB approach (jointly referred to as the 'advanced approaches') for calculating exposure to credit risk in respect of positions held in the banking book.
2. Banks should make provision for a period of up to 18 months between submitting a completed IRB application pack and approval being granted or denied.
3. All banks applying to adopt the advanced approaches will be required, once advised by this Office, to undertake a parallel reporting run for a minimum of six months for the affected portfolios prior to using such approaches in capital calculations. This parallel run period will be performed during the above-mentioned 18 month application period. The aim of the parallel run is to give both the applicant bank and the Bank Supervision Department (BSD) comfort that the applicant bank has tested its systems for management and regulatory reporting purposes, and will be able to successfully use them for capital calculations by the end of the parallel run period. The capital impact of the models will also be monitored and assessed by BSD during the parallel run period. The parallel run submissions are in addition to the regular BA returns submitted by banks and applicant banks should therefore liaise with BSD for arrangements with regard to the parallel run submission process.
4. The IRB application process consists of two stages. The first stage requires the applicant bank to complete the IRB application pack, which provides summary information on its plans for IRB implementation and its approach to a number of key areas such as governance and the use of internal ratings. The second stage requires BSD to carry out an on-site focused review at the bank to assess areas identified for follow-up (during the review of the IRB application pack submitted) to determine whether the applicant bank will be able to meet the minimum requirements. BSD is likely to request further detailed information if deemed necessary.
5. Banks are expected to be in a reasonable state of readiness when they apply for approval to adopt the advanced approaches, which would include having a clear and realistic roll-out plan covering the material portfolios for inclusion in the advanced approaches. BSD will rely on preparatory work undertaken by the banks themselves, with a key element in this regard being the involvement of senior management in the approach being considered, including the requirement for the information submitted by banks being signed off by the applicant bank's chief executive officer.
6. When compiling information requested in the sections below, banks should provide concise responses. Where necessary, applicant banks may refer to supporting documentation, which BSD can request during stage two of the IRB application process. The primary aim of the information is to enable BSD to determine the scope of its supervisory review work in respect of assessing a bank's IRB application (as part of stage two of the application) and the bank should bear this in mind when formulating its application.

Information to be provided by a bank, controlling company or branch of a foreign institution

Section A: General overview of application

1. Overview of IRB implementation plan and key milestones, including an overview of the external expertise or internal expertise used within the group.
2. A summary of why the bank is applying for use of the advanced approaches and what it aims to achieve as a consequence.
3. Overview of the group and legal entity structure.
4. Scope of the application, setting out the approaches being applied for, including the business lines, portfolios and legal entities (mapped to the different asset classes per the form BA 200) to which the approach will apply.
5. Detail of portfolios for which the bank wishes to apply for any permanent exemptions.

Section B: Corporate governance and oversight

6. Review of governance of the IRB implementation process (including a brief overview of how it fits into the governance process at a group level):
 - 6.1 Description of the governance process.
 - 6.2 Model development and maintenance.
 - 6.3 Independent validation, including a motivation for structural independence and appropriate incentive structure.
7. Copy of the board-approved credit policy and a description of future changes planned.
8. Copies of the board-approved model validation, development and monitoring policies, where relevant.

Section C: Internal ratings-based approaches self-assessment

9. Complete and submit schedules 1, 2 and 3 of the self-assessment (refer to <http://www.reservebank.co.za>> Regulation and supervision> Bank Supervision> International standards> Internal ratings-based approaches: Application process and Self-assessment and long-form review templates).

Section D: Rating and risk estimation systems

10. Complete Annexure B for each model that will be used for the IRB approach. The application pack shall include all relevant documentation as described in point 8 of Annexure B.
11. Complete and submit a Credit Risk Rating System Register (refer to <http://www.reservebank.co.za>> Regulation and supervision> Bank Supervision> International standards> Internal ratings-based approaches: Application process and Self-assessment and long-form review templates).
12. The process followed in tailoring the models for the South African environment and the branch management's input into the development of the models.¹
13. Description of how the bank meets the experience requirement, elaborating on the time that the rating/scoring systems have been in operation.
14. Summary of the level of compliance with the use test requirements, specifically describing how the rating systems form an integral part of:
 - 14.1 Credit approval.
 - 14.2 Reporting of credit risk information: description of reports produced using data of the model.
 - 14.3 Risk management and internal capital allocation process.
15. Outline the differences, if any, between the parameter estimates used for regulatory capital purposes and those for internal purposes.

Section E: Stress testing

16. Description of the bank's approach to credit risk stress testing. In particular, describe the level of compliance with the requirements specified in regulation 23(11)(b)(ix) of the Regulations.

Section F: Technological environment, data maintenance and regulatory reporting requirements

17. Description of the bank's approach to data management, with reference to the applications used to store information relating to the rating system, the estimated parameters and any other relevant aspect. In particular, describe the level of compliance with the requirements specified in regulation 23(11)(b)(viii) of the Regulations.
18. The process followed to obtain calibration databases and regulatory capital figures, including an overview of the regulatory reporting system and whether the bank would be in a position to complete and submit the risk-based returns within the periods specified in regulation 7 of the Regulations.

Section G: Independent validation

19. Description of the bank's approach to validation, with reference to:

19.1 Back testing. Analysis of the differences between the parameter estimates (PD, LGD and EAD) and the realised default rates, loss severities and EAD amounts.

19.2 Performance monitoring. Description of tests used to validate the accuracy, stability, discriminatory power and calibration of the rating systems.

19.3 Benchmarking. Comparison of parameter estimates across banks and/or external benchmarks.

20. Staffing of validation unit, including approved vacancies and skillset.

Section H: Declaration by the Chief Executive Officer (attached)

Section I: Declaration by the Chairperson of the Board of Directors (attached)

Note: Please supply responses to this questionnaire and supporting documentation either electronically to SARB-BANKSUP@resbank.co.za or via hard medium such as CD or memory stick.

Section H: Declaration by the Chief Executive Officer

Declaration constituting the formal application for approval for use of the IRB approach in respect of credit risk exposures for purposes of determining the minimum required regulatory capital to be held

- I, the undersigned, hereby declare that I have carefully worked through the content of the information that is being submitted as part of the application for permission to use the IRB approach to calculate minimum required capital and reserve funds relating to credit risk.
- I declare that this information is correct, complete, accurate and truthful and presents a true picture of the situation at (name of bank) on the basis of which BSD can form an appropriately informed judgement on the application.
- I undertake to notify BSD immediately if there is a significant change to the information given in the application pack. I hereby also acknowledge that if I fail to do so, this may result in a delay in the application process.

Signed at....., this.....day of (month and year)

.....

Signature: Chief Executive Officer

Section I: Declaration by the Chairperson of the Board of Directors

Declaration constituting the formal application for approval for use of the IRB approach in respect of credit risk exposures for purposes of determining the minimum required regulatory capital to be held

- I sign this application on behalf of every legal entity making the application.
- I confirm that the information submitted in the application pack represents a true and fair view, to the best of my knowledge and belief, and that I have taken all reasonable steps to ensure that this is the case.
- I confirm that I am aware that it is an offence to provide BSD, knowingly or not, with information that is false or misleading.
- I give consent to make the records that demonstrate (name of bank's) compliance with the IRB minimum requirements available to BSD upon its request.
- I confirm that I give consent for any information provided in relation to this application to be shared with other local and/or international regulators at BSD's discretion.

Signed at....., this.....day of (month and year)

.....

Signature: Chairperson of the Board of Directors

Annexure B: Summary of model to be used for internal ratings-based approach

Table 1: Summary information

1.	Bank name	
2.	Rating system	Name: Unique number: Type (PD, LGD, EAD):
3.	Brief description of model methodology	
4.	Model weaknesses and limitations: description of any known weaknesses of the models and anticipated timetable for remedying or improving them	
5.	Portfolio(s)/business units covered by the rating system	
6.	Asset class(es) affected by the rating system	
7.	Relevant committee approval	Committee: Date:
8.	Supporting documentation for rating system	Development documentation Validation documentation Documentation presented to approval committee Approval committee minutes Other supplementary material

Table 2: Parameter estimates and capital information

As at: ¹	Exposure (R'm)	EAD (R'm)	EAD weighted PD (%)		EAD weighted LGD (%)		Expected loss (R'm)	Risk weighted assets (R'm) ²	Capital requirement (R'm) ³
			Point in time	Long Run Average	Downturn	Long Run Average			
Performing loans									
Non-performing loans ⁴									

¹ This table needs to be completed when the IRB application pack is submitted and for every month of the parallel-run reporting period

² Scalar of 1.06 should be included within the risk weighted assets (RWA)

³ Calculated using RWA x minimum required capital percentage + expected losses

⁴ Non-performing loans i.e. exposures that are in default as defined in Regulation 67