

**OFFICIAL INFORMATION
OF THE CZECH NATIONAL BANK**
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regarding the prudential rules for banks, credit unions and investment firms

The Internal Ratings Based Approach to Calculate the Capital Requirement for Credit Risk

The Czech National Bank hereby provides the following information with regard to Articles 91 and 100 of Decree No. 123/2007 Coll., stipulating the prudential rules for banks, credit unions and investment firms (hereinafter the "Decree"):

- I. The use of internal ratings and loss estimates in the risk management and the decision-making and managerial processes of the liable entity is understood as follows:**
1. The role and the use of internal ratings, loss estimates and default estimates applied in calculating capital requirements, and associated systems and processes in the risk management and the decision-making and managerial processes of the liable entity pursuant to Article 91, 1, b) of the Decree, taken together, are referred to as the use test for the IRB Approach (hereinafter the "use test").
 2. 'Use test' shall mean that the IRB approach is an integral part of the overall governance, including the risk management system, of the liable entity and plays an important role in it. The liable entity must be able to demonstrate in the context of the use test that the use of the IRB Approach is not limited to regulatory purposes and the utilisation of the individual elements of the IRB Approach in the decision-making and managerial processes of the liable entity provides enough automatic internal motives for constantly maintaining the IRB Approach sufficiently accurate, up-to-date and reliable. The liable entity shall explain whether the elements of the IRB Approach are used in its processes fully and directly or partly and in an adjusted manner.
 3. The Czech National Bank expects that the liable entity shall include the IRB Approach in the following activities and procedures:
 - a) The main areas:
 1. the loan approval procedure,
 2. the introduction of a system of limits for credit risk management, including specific limits, e.g. for individual counterparties and individual portfolios,
 3. the internal reporting of credit risk,
 4. the introduction and utilisation of the fundamental criteria, which are used in the internal rating system, also in other credit risk-related activities and procedures (e.g. monitoring exposures, implementing credit risk mitigation techniques, pursuing non-performing receivables).
 - b) The broader areas:
 1. the establishment of value adjustments to exposures,

2. the distribution of internal capital and the assessment of the capital requirement for credit risk being in accordance with the Decree,
 3. the assessment of the risk appetite of the liable entity,
 4. the assessment of the business strategy and the approach to attracting new clients,
 5. the pricing,
 6. the evaluation of the profitability and performance of the liable entity.
4. In granting approval to use the IRB Approach an emphasis will be put on the part of the Czech National Bank on the compliance of the use test in the main areas. The Czech National Bank will accept it if full compliance is not achieved from the very start, i.e. as at the date the approval to use the IRB Approach is granted by the competent authority. An emphasis will be put on the ability of the liable entity to demonstrate that all the areas of the use test are included in the implementation plan in accordance with the nature, scope and complexity of the activities of the liable entity.
 5. A significant role of the IRB Approach in the overall governance of the liable entity does not automatically imply its exclusive or primary role. Elements of the IRB Approach (e.g. data, ratings and risk parameters) used for the regulatory calculation of the capital requirement for credit risk do not have to be identical in all cases with the inputs used for the credit risk management of the liable entity, but they must be interconnected. (For example, the amount of allowances established in keeping with valid accounting standards is not expected to be in full agreement with the amount of expected losses calculated according to the IRB Approach. On the other hand, there is an expectation that the internal usage of ratings and risk parameters will be in harmony with the area of approving loans and setting the system of limits.)
In case the elements of the IRB Approach are used in the processes of the liable entity only partly or in an adjusted manner in some instances the liable entity must be able to provide justification for this approach, to explain the interconnection between the elements of the IRB Approach and the inputs used in its processes. The liable entity regularly examines such differences, including their extent and the reasons for their origination.
 6. In general, a higher degree of the use test is expected in the case of the banks which intend to perform its own estimates of the values of loss given defaults and/or conversion factors under the IRB Approach (the so-called AIRB Approach) than in the case of the banks which intend to estimate only the probability of default under the IRB Approach.

II. In using the Standardised Approach as part of the IRB Approach pursuant to Article 100 of the Decree immateriality is understood as follows:

1. A liable entity that implements the IRB Approach may, with the approval of the competent authority, use the Standardised Approach, inter alia, for those exposure categories which are immaterial from the point of view of their magnitude and their risk profile in the credit risk area. An indicator for the magnitude is, in the opinion of the Czech National Bank, the exposure amount; an indicator for the risk profile is the risk-weighted exposure amount.

2. The materiality threshold is primarily related to the aggregate level, i.e. the level of the applicant (consolidated or individual) who has submitted an application to use the IRB Approach. The individual level (for example, the level of an organisation unit within a regulated consolidated group) is to be used as a supplementary threshold. The liable entity shall set the materiality threshold with regard to the nature of its exposures; the materiality threshold, along with its justification, shall be submitted as part of the application for approval to use the IRB Approach.
3. The Czech National Bank will pay attention, in particular, to satisfying itself that the liable entity does not exclude high risk exposures from the IRB Approach with the aim of achieving a reduction in the capital requirements, although the risk parameters can be estimated without major obstacles.
4. The liable entity shall constantly verify that the materiality threshold is observed in the case of the exposures where the Standardised Approach is used as part of the IRB Approach on the basis of immateriality.

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