

DE NEDERLANDSCHE BANK N.V.

## **Policy Rule on Partial Use of the Standardised Approach under the IRB Approach**

*Policy Rule of De Nederlandsche Bank N.V. of 11 December 2006, no. Juza/2006/02369/IH, providing for rules pursuant to Article 76(1) of the Decree on Prudential Rules for Financial Undertakings (Besluit prudentiële regels Wft) regarding the manner of exercising the powers delegated to it in that Article (Policy Rule on Partial Use of the Standardised Approach under the IRB Approach)*

De Nederlandsche Bank N.V.;

Having regard to Article 76(1) of the Decree on Prudential Rules for Financial Undertakings (*Besluit prudentiële regels Wft*);

Having consulted the representative organisations;

Decides:

### *Article 1*

For the purposes of this Policy Rule, the following terms shall be defined as follows:

- (a) *applicant*: a bank or investment firm which has submitted an application for approval, as referred to in Article 76 of the Decree, to De Nederlandsche Bank;
- (b) *Decree*: the Decree on Prudential Rules for Financial Undertakings (*Besluit prudentiële regels Wft*);
- (c) *De Nederlandsche Bank*: De Nederlandsche Bank N.V.;
- (d) *financial undertaking*: a bank or investment firm;
- (e) *IRB approach*: the internal ratings-based approach as referred to in Article 1 of the Decree, and
- (f) *Regulation*: the Supervisory Regulation on Solvency Requirements for Credit Risk (*Regeling solvabiliteitseisen voor het kredietrisico*).

### *Article 2*

This Policy Rule shall apply to banks or investment firms which submit an application to De Nederlandsche Bank for permission as referred to in Article 76 of the Decree.

### *Article 3*

1. For the purposes of Article 76(1), under (a), of the Decree, the condition stated therein shall be satisfied if:
  - (a) the applicant shows that the exposure class in question does not involve major risks;
  - (b) the applicant demonstrates that the number of material counterparties in the exposure class in question is so small that the assumption of sufficient granularity does not hold, and
  - (c) the applicant shows that the development of a rating system meeting the requirements of Chapter 3 of the Regulation is not possible or would involve disproportionately high costs of implementation.
2. The condition referred to in paragraph 1, under (a), above shall be satisfied anyway if the applicant shows that the majority of the counterparties in the exposure class in question has an external rating.

### *Article 4*

For the purposes of Article 76(1), under (b), of the Decree, the condition stated therein shall be satisfied if:

- (a) the applicant shows that it seeks to ensure the fullest possible application of the IRB approach throughout the financial undertaking;
- (b) the applicant shows that the credit risk-weighted exposure amounts of the total of the exposures for which it seeks permission to exclude them from the IRB approach represent less than 15% of the total credit risk-weighted exposure amounts.
- (c) the applicant has procedures in place ensuring that the 15% limit referred to under (b) above is monitored periodically, and
- (d) the applicant has procedures in place ensuring that its regulatory capital requirements are not affected by intra-group transactions which solely seek to benefit from differences between the available approaches for the determination of the regulatory capital requirements for credit risk as referred to in the Regulation.

#### *Article 5*

1. If, in structural terms, the credit risk-weighted exposure amounts of the total of exposures for which permission is sought to exclude them from the IRB approach exceed 10% of the total credit risk-weighted exposure amounts, the applicant shall, in regard of those exposures that will, in due course, be the first to be subjected to the IRB approach, collect the following information:

- (a) for exposures in the exposure classes listed in Article 71(1), under (a), (b) or (c), of the Decree: the information listed in Article 3:74(2), under (e) and (f), of the Regulation, and the information referred to in Article 3:74(4), under (e) and (g), of the Regulation, to the extent that it relates to realised defaults;
- (b) for exposures in the exposure class listed in Article 71(1), under (d), of the Decree: the information listed in Article 3:75(2), under (c), (d) and (e), of the Regulation, to the extent that it relates to realised defaults.

2. Notwithstanding the provisions of paragraph 1 above, the applicant may choose to collect on an ongoing basis, as from the time of implementation, the information referred to in paragraph 1 above for substantial portfolio elements for which the permission referred to in Article 76(1), under (b), of the Decree has been granted.

#### *Article 6*

1. The permission referred to in Article 76(1), under (b), of the Decree shall be refused if the application seeks to achieve that, within a business entity, only part of the exposures forming part of a category listed in Article 71(1) of the Decree will be subjected to the IRB approach.

2. Notwithstanding the provisions of paragraph 1 above, subjecting part of the exposures to the IRB approach shall be permitted if the applicant shows that:

- (a) the development of a rating system meeting the requirements referred to in Chapter 3 of the Regulation is not possible or would involve disproportionately high costs of implementation, and
- (b) the choice to subject part of the exposures to the IRB approach is not underlain by reasons of capital arbitrage.

#### *Article 7*

This Policy Rule shall be cited as the Policy Rule on Partial Use of the Standardised Approach under the IRB Approach.

#### *Article 8*

This Policy Rule shall enter into force at the date of entry into force of Article 76 of the Decree.

This Policy Rule and the appurtenant explanatory notes shall be published in the *Staatscourant*.\*

*De Nederlandsche Bank N.V.*,

*/s/ A. Schilder*  
*Executive Director*

*/s/ D.E. Witteveen*  
*Executive Director*

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\* Government Gazette.

## Explanatory notes

### *Legal basis*

Pursuant to Article 89 of the recast Banking Directive<sup>1</sup>, banks and investment firms which use the internal ratings-based approach as referred to in Chapter 3 of the Supervisory Regulation on Solvency Requirements for Credit Risk (*Regeling solvabiliteiseisen voor het kredietrisico*) (hereinafter referred to as the IRB approach) may be granted permission to exclude certain exposures from the scope of the IRB approach and to subject them to the standardised approach as referred to in Chapter 2 of said Regulation. This possibility is known as the ‘partial use’ of the standardised approach.

Article 89 of the recast Banking Directive has been implemented in Article 76 of the Decree on Prudential Rules for Financial Undertakings (*Besluit prudentiële regels Wft*). Paragraph 1 of that Article empowers De Nederlandsche Bank to grant or refuse applications from banks and investment firms as referred to above for permission to make partial use of the standardised approach. Under Article 4:81(1) of the General Administrative Law Act (*Algemene wet bestuursrecht*), De Nederlandsche Bank may set policy rules regarding the manner in which it will exercise the powers delegated to it as referred to in Article 76(1) of the Decree on Prudential Rules for Financial Undertakings (*Besluit prudentiële regels Wft*). This has been done in the present Policy Rule.

The present Policy Rule does not provide a detailed elaboration, so as to do justice to the principle-based nature of the recast Banking Directive and the national legislation and regulations based on the Directive. Consequently, each decision as to whether the conditions referred to in Article 76 of the Decree on Prudential Rules for Financial Undertakings (*Besluit prudentiële regels Wft*) are satisfied will be based on an individual assessment focusing on the specifics of the application.

### *Scope*

The rules on granting or refusing permission to make partial use of the standardised approach for eligible exposures form part of the framework set by the Decree on Prudential Rules for Financial Undertakings (*Besluit prudentiële regels Wft*). More specifically, the present Policy Rule concerns the assessment of applications as referred to in Article 76(1), under (a) and (b), of the Decree on Prudential Rules for Financial Undertakings (*Besluit prudentiële regels Wft*).

### *Preparation and consultation*

When the present Policy Rule was drafted, consultations were held with the Ministry of Finance. Subsequently, in line with prevailing practice, the present Policy Rule was presented for consultation (initially as part of the draft Supervisory Regulation on Solvency Requirements for Credit Risk (*Regeling solvabiliteitseisen voor het kredietrisico*)) to the representative organisations of the financial undertakings covered by the Policy Rule.

### *Administrative costs*

Administrative costs for the business sector are defined as the costs incurred by the business sector in order to comply with the information requirements ensuing from public sector legislation and regulation. This definition is to be found on page 8 of the report ‘*Meten is weten*’ (To measure is to know) of the Interdepartmental Project Management

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<sup>1</sup> Directive 2006/48/EC of the European Parliament and of the Council of 14 June 2006 relating to the taking up and pursuit of the business of credit institutions (recast) (OJ L 177).

Administrative Costs (*Interdepartementale projectdirectie administratieve lasten (IPAL)*). The obligation to provide evidence and to collect certain information, as provided for in Articles 3 to 5 of the present Policy Rule, involves administrative costs. Administrative costs are calculated on the basis of the so-termed standard cost model of the Advisory Committee on Administrative Costs (*Adviescollege toetsing administratieve lasten*). Under this model, the aggregate administrative burden (in quantitative terms) ensuing from a certain piece of regulation is equal to the outcome of the following formula:

$P (\text{rate} * \text{time}) * Q (\text{number of enterprises} * \text{frequency})$

The calculations required under the formula are based on the answers to the following questions:

- (a) What is the number of acts ensuing from a certain information requirement?
- (b) What is the time required to perform these acts?
- (c) What are the rates for the performance of these acts?
- (d) How many enterprises (that is, financial undertakings) have to perform these acts?
- (e) What is the frequency with which these acts must be performed?

In terms of the information requirements identified above, this produces the following results:

- (a) Expectations are that the application for permission to make partial use of the standardised approach will, depending on the number and type of exposures concerned, involve the steps listed in Articles 3 to 5.
- (b) Expectations are that the application will require an effort totalling 50 hours.
- (c) According to the so-termed baseline measurement conducted by the Ministry of Finance, the costs involved in providing information are € 90 per hour for a bank and € 75 per hour for an investment firm.
- (d) In principle, all undertakings that may be expected to be able to apply the IRB approach are eligible for partial use of the standardised approach. These are the 24 large investment firms and the 36 medium-sized to very large banks from the baseline measurement.
- (e) The acts will have to be performed once by each financial undertaking submitting an application.

Hence, the administrative costs involved in submitting the applications are:

For investment firms:  $(€ 75 * 50 \text{ hours}) * (24 * \text{frequency } 1) = € 90,000$ .

For banks:  $(€ 90 * 50 \text{ hours}) * (36 * \text{frequency } 1) = € 162,000$ .

The present Regulation was submitted in draft form to the Advisory Committee on Administrative Costs (*Adviescollege toetsing administratieve lasten*) on 17 October 2006. The Committee decided not to select the draft Regulation for further scrutiny.

### *Notes to individual Articles*

#### *Article 1*

For the definition of terms used in the present Policy Rule which are not defined in Article 1, the reader is referred to Section 1:1 of the Financial Supervision Act (*Wet op het financieel toezicht*), Article 1 of the Decree on Prudential Rules for Financial Undertakings (*Besluit prudentiële regels Wft*) and Articles 1:1 and 3:1 of the Supervisory Regulation on Solvency Requirements for Credit Risk (*Regeling solvabiliteitseisen voor het kredietrisico*).

#### *Article 3*

Pursuant to Article 76(1), under (a), of the Decree on Prudential Rules for Financial Undertakings (*Besluit prudentiële regels Wft*), banks and investment firms using the internal ratings-based approach as referred to in Chapter 3 of the Supervisory Regulation on Solvency Requirements for Credit Risk (*Regeling solvabiliteitseisen voor het kredietrisico*) may exclude their public sector exposures and/or their exposures to financial undertakings from the scope of the IRB approach and subject them to the standardised approach, provided that the explicit consent of De Nederlandsche Bank has been obtained. In order to prevent financial undertakings which opt for the IRB approach from excluding major components of their exposures from the scope of this approach, this consent is made subject to two strict conditions, underlain by the provisions of the recast Banking Directive. Under the Directive, the number of material counterparties must be relatively limited, and it must be unduly burdensome for the financial undertaking to introduce a rating system for these counterparties. The interpretation of the subjective concepts of ‘limited’, ‘material’ and ‘unduly burdensome’ depends on the case in hand, but it should be noted that this possibility is intended for stable portfolios where the development of a risk-sensitive risk management framework would involve disproportionately high cost levels. In order to come to some degree of risk sensitivity and to prevent high-risk exposures from unjustly being assigned low risk weightings under the standardised approach, the fact that counterparties have external ratings is considered a plus when assessing the application. Whether or not permission should be granted for the use of the standardised approach for public sector exposures and/or exposures to financial undertakings as referred to in Article 1:1 of the Financial Supervision Act (*Wet op het financieel toezicht*) will be assessed by looking at the highest consolidated level of the financial undertaking. De Nederlandsche Bank does not intend to specify a number of counterparties, because it holds that this would be out of line with the principle-based approach taken in the recast Banking Directive and the recast Capital Adequacy Directive<sup>2</sup>. Meeting the criterion of a limited number of material counterparties may depend on the size of the financial undertaking. Hence, a certain number of counterparties may be regarded as limited for one (very large) financial undertaking, whereas it may not be so regarded for another (medium-sized) financial undertaking. The risk associated with the counterparties also influences the assessment of materiality. If, for the financial undertaking as a whole, the number of counterparties is limited, the relevant exposures may be subjected to the standardised approach. If this is not the case and if the exposures in question are not covered by one of the other exemptions from the IRB approach, the financial undertaking must, in order to qualify for the use of the IRB approach, develop a rating system and subject the category concerned to the IRB approach.

#### *Article 4*

Pursuant to Article 76(1), under (b), of the Decree on Prudential Rules for Financial Undertakings (*Besluit prudentiële regels Wft*), banks and investment firms using the IRB approach may, with the explicit consent of De Nederlandsche Bank, exclude non-material operations or, in this case, non-material exposures from the scope of the IRB approach. In that case, the risk-weighted exposure amounts for such exposures are determined using the standardised approach. This possibility has a major influence on the extent to which the IRB approach needs to be rolled out within a financial undertaking. Hence, De Nederlandsche Bank holds that permission to use this

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<sup>2</sup> Directive 2006/49/EC of the European Parliament and of the Council of 14 June 2006 on the capital adequacy of investment firms and credit institutions (recast) (OJ L 177).

possibility should depend on fulfilment of a number of criteria and should be made subject to a number of conditions.

De Nederlandsche Bank assumes that a financial undertaking which opts for the IRB approach will roll out the approach in full, unless a specific business entity or an exposure class as referred to in Article 71(1) of the Decree on Prudential Rules for Financial Undertakings (*Besluit prudentiële regels Wft*) is not material. It is obvious that the degree of materiality should primarily be assessed on the basis of a percentage of the risk-weighted exposure amounts under the standardised approach. However, this is not the only feature that should be taken into account. Other features that may be indicative of materiality are the amount of internally allocated capital, an estimate of the risk weights under the IRB approach, provisions for loan losses and the share of the exposures not subject to the IRB approach in total net (interest) income. An exception is constituted by the exposure class referred to in Article 71(1), under (e), of the Decree on Prudential Rules for Financial Undertakings (*Besluit prudentiële regels Wft*), for which the determination of materiality has already been provided for in the recast Capital Adequacy Directive.

The limit of 15% set in Article 4, under (b), is determined after exclusion of exposures which are otherwise exempted from the IRB approach, such as non-material equity exposures, for which the Decree on Prudential Rules for Financial Undertakings (*Besluit prudentiële regels Wft*) grants a separate exemption on the basis of the recast Capital Adequacy Directive if the exposures are less than 10% of the financial undertaking's actual own funds. Decisive is the ratio of the risk-weighted exposure amounts of the exposures which are excluded from the scope of the IRB approach under this exemption (numerator) to the risk-weighted exposure amounts of all exposures if not otherwise exempted from the IRB approach (denominator). The percentage must be determined at the level of the overall financial undertaking and not separately for each business entity or exposure class. A financial undertaking should not interpret this 15% limit the other way round by holding that only 85% of the risk-weighted exposure amounts should be subject to the IRB approach. On the contrary, the aim should be 100% coverage of the IRB approach, but in certain cases part of the exposures may be exempted. Likewise, a financial undertaking should not seek to take advantage of the 15% limit by excluding one or a few large entities from the IRB approach. The possibility offered in the present Policy Rule is intended for several smaller business entities of a financial undertaking, for which the development and implementation of a rating system meeting the relevant requirements is not possible or would involve disproportionately high costs of implementation.

In order to prevent a financial undertaking from splitting up its organisation into a large number of 'immaterial' entities, the interpretation of the term business entity will have to reflect the definitions used in the financial undertaking's risk management system. Indicators for business entities could be: RAROC, bonus system, integrated management, responsibility borne by one manager. This aspect will be the focus of special attention when an application is submitted for the permission referred to in Article 76(1), under (b), of the Decree on Prudential Rules for Financial Undertakings (*Besluit prudentiële regels Wft*).

One consequence of the introduction of the Basel II capital framework is an enhanced risk sensitivity of the capital requirements. The risk sensitivity depends on the approach taken, the advanced IRB approach being the most risk-sensitive. Under the advanced IRB approach, low risk are assigned a lower weighting and high risks a higher weighting than, for instance, under the standardised approach. If a single approach is applied throughout a financial undertaking, this presents no problems, since, on average, the amount of regulatory capital will reflect the overall risk exposure. However, if a financial undertaking uses several approaches side by side, that undertaking must be

prevented, from a prudential perspective, from attempting to minimise its regulatory capital by applying the IRB approach to as many low-risk exposures as possible and applying the standardised approach to as many high-risk exposures as possible. A financial undertaking might do so by assigning high-risk exposures to small, non-material business entities and then applying for permission to use the standardised approach for such entities. De Nederlandsche Bank does not intend to prohibit intra-group transactions between entities using different approaches, since that would unduly severely affect financial undertakings' normal business operations. However, it is important that financial undertakings should have procedures in place for intra-group transactions between entities that apply different approaches so that it can be established that such transactions are underlain by reasons relating to normal business operations and not by reasons pertaining to capital arbitrage.

#### *Article 5*

Materiality is not a static condition, so that exposures that are initially excluded from the IRB approach for reasons of materiality may have to be brought within its scope at a later point in time. Hence, Article 5(1) requires that financial undertakings also collect certain IRB-relevant data for elements of their portfolios which are not subject to this approach for reasons of materiality. This has an advantage in that financial undertakings are thus forced to deliberately prepare for the application of the IRB approach to elements of their portfolios which, though currently exempted from that approach, may have to be subjected to it in the future. In addition, the relevant requirement encourages the widest possible application of the IRB approach within a financial undertaking. The IRB-relevant data are those concerning realised defaults, LGDs and conversion factors. In order to be able to collect these data, financial undertakings must, for the portfolio elements in question, have established a definition of default in accordance with that used in the Decree on Prudential Rules for Financial Undertakings (*Besluit prudentiële regels Wft*). As an alternative to the collection of IRB-relevant data under Article 5(1), a financial undertaking may select one or more relatively large elements of the exposure class concerned and collect IRB-relevant data for those elements from the very start. The expression 'relatively large elements' may be taken to mean, for instance, elements representing a portfolio share of 5% or more.

#### *Article 6*

Article 6 provides that, within a business entity, the IRB approach must, in principle, be implemented in full for each exposure class. Despite this basic principle, De Nederlandsche Bank recognises that scope should be offered for a broad interpretation of the term 'business entity'. This is also made possible by the fact that this concept is not defined in the recast Capital Adequacy Directive. Unlimited application of the possibility to exclude exposures from the IRB approach on the basis of materiality would offer undue scope for capital arbitrage and is, hence, undesirable from the point of view of De Nederlandsche Bank. In principle, De Nederlandsche Bank will thus expect the IRB approach to be fully rolled out within a business entity, but may depart from this principle if the financial undertaking shows that this would involve disproportionately high costs and, moreover, that it does not seek capital arbitrage.

*De Nederlandsche Bank N.V.,*

*/s/ A. Schilder  
Executive Director*

*/s/ D.E. Witteveen  
Executive Director*