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SUBJECT: Guidance for Independent Verification of a Banking Organization's Advanced Approaches Systems

This document provides guidance regarding the governance and the control environment for banks and bank holding companies (referred to hereafter as "banking organizations") subject to the Federal Reserve Board's advanced approaches risk-based capital rule (rule).¹ The governance and control environment should incorporate independent verification, as well as promote the accuracy of inputs to risk-based capital calculations and the banking organization's overall safe and sound operations.

Background

Under section 22(j)(3) of the rule, banking organizations must have an effective system of controls and oversight that ensures ongoing compliance with the qualification requirements in section 22 of the rule. Supervisors have found that organizations have independent verification in many areas, including a middle office price-verification function of market risk groups and a loan-review function that assesses the design and application of rating systems and processes, as well as within model validation. However, many banking organizations do not have rigorous internal control processes in certain other areas where the rule is relatively complex, such as in identifying securitization exposures, determining immaterial leverage for equity exposures, and identifying "non-material" portfolios.

Supervisors have observed that areas lacking independent verification processes, including effective internal challenge processes, often experience higher rates of error in applying the rule.

This is especially problematic for more complex aspects of the rule, where significant judgment is required or where decisions may materially affect risk-weighted assets calculations. An independent verification process that effectively challenges the rigor and accuracy of a banking organization's approach helps to ensure initial and ongoing compliance with the rule. Supervisors expect banking organizations to exercise rigorous control and challenge processes that are commensurate with the scope and complexity of each rule requirement.

¹ 12 CFR part 208, appendix F (state member banks), and 12 CFR part 225, appendix G (bank holding companies).

The purpose of independent verification is to promote accuracy in applying the mechanics of the rule to ensure data and reporting integrity. As required by section 22(i)(1), a banking organization “must have data management and maintenance systems that adequately support...the timely and accurate reporting of risk-based capital requirements.” Independent verification is particularly important when heightened complexity could lead to misstatements of capital, because, as required under 22(a)(3) of the rule, a banking organization “must have an appropriate infrastructure with risk measurement and management processes that...are appropriate given the [bank]’s size and level of complexity.”

General Implementation Guidance

Banking organizations should have a rigorous internal control framework to ensure that all internal systems supporting rule compliance are properly designed, documented, and implemented. The depth and sophistication of a banking organization’s internal control processes for each requirement of the rule should be commensurate with the complexity and materiality of the requirement.

The internal control framework should include periodic reviews aimed at ensuring the accurate and consistent application over time of systems supporting rule compliance. Moreover, for systems having a significant impact on the accuracy of risk-weighted assets or involving more complex or subjective elements, the internal control framework should include effective independent verification. Effective independent verification by qualified individuals is especially critical in the areas of new products or product modifications, data capture, data aggregation, risk measurement, regulatory capital assignment and reporting, and information technology. To be effective, independent verification should be carried out by qualified individuals who understand the rule and relevant products and portfolios, have the requisite technical knowledge to evaluate the systems, and have sufficient incentives and stature within the banking organization to ensure an effective challenge process.