IRB Mortgage Risk-Weight 'Snapshot' Survey 2024

Introduction

The landscape of regulatory credit risk capital has evolved considerably since our 2022 Internal Ratings Based (IRB) benchmarking survey. Firms are moving ever-closer to having their new retail mortgage IRB models approved by the PRA, following an iterative review and feedback process, which has been subject to a number of challenges. Consensus appears to have emerged on many of the key decision points, including areas covered in detail in our previous survey, e.g. the economic cycle definition, number of risk grades etc.

Almost all firms have now submitted their new suite of models, including a number of submissions made towards the end of 2023 and early 2024, and are waiting for formal feedback from the PRA. Given the significance of mortgage risk weights (RWs) to the UK market, these submissions and final RW positions remain a critical component of firms' business plans. The expectation is that firms will start to receive feedback on these submissions in H2 2024 and beyond.

We have used this inflection point as an opportunity to take stock of the current RW position from these latest IRB models. A total of 11 firms have participated in this survey, covering both Owner-Occupied (OO) and Buy-to-Let (BTL) lending, with all firms having received feedback from the PRA (9 of which have either re-submitted and are waiting for further communication, or have received formal approval). We have compared the model outputs to other sources of RW information, including the standardised (SA) requirements under the PRA's Consultation Paper on the implementation of Basel 3.1 standards (CP16/22).

14.4%

Portfolio average OO IRB RWs

22.3%

Portfolio average BTL IRB RWs

Portfolio-level

The first graph shows the distribution of portfolio-level RWs across participants for both OO and BTL portfolios, with simple average RWs at portfolio level of 14.4% and 22.3% respectively. This is broadly consistent with the results of our 2022 survey and represents a significant increase from incumbent models, with single-digit RWs now a thing of the past.

The results segmented by performing / non-performing show a similar trend, with average RWs for BTL significantly higher across both segments (performing RWs of 13.6% and 21.0% for OO and BTL respectively). This reflects the additional prudence within both the PD and LGD models for BTL portfolios, driven by a number of thematic feedback points from the PRA.

The divergence in RWs has reduced considerably compared to the 2022 survey. This aligns with one of the key aims of the IRB Roadmap requirements and demonstrates a convergence through PRA feedback and subsequent remediation activities.

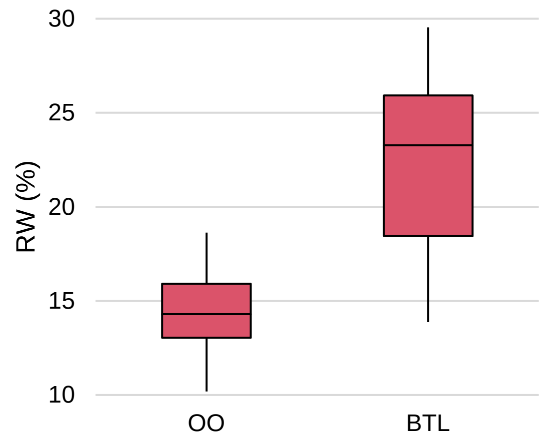

Figure 1. Portfolio-level RWs

The box plot shows the range and lower, middle and upper quartiles separately for OO and BTL. Note that these include both performing and non-performing exposures, and statistical outliers have been excluded.

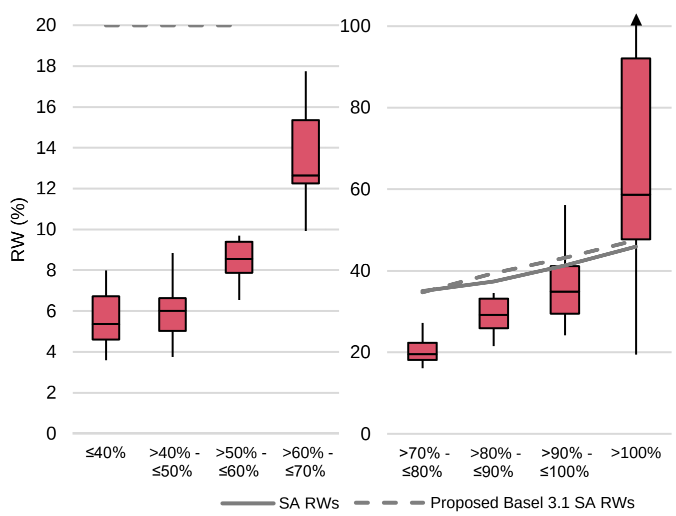

Figure 2. Owner-occupied performing RWs by LTV band

Note: the 35% SA RW is not included on the ≤ 70% LTV band graph due to the axis scale

Owner-Occupied

The LTV-level performing RWs for OO remain broadly consistent with the levels observed in our 2022 survey. We have also compared the IRB RWs against SA requirements, based on both the current RWs by LTV band and the proposed RWs under CP16/22. Note that this is a simplified comparison at LTV level, and hence does not reflect some other changes proposed under CP16/22 (such as the use of origination valuations when determining LTV) or some of the inherent differences between SA and IRB RWs. The implementation of CP16/22, which is still in consultation phase, is due to considerably narrow the gap between SA and IRB firms in the lower LTV bands, although there still remains a potential capital benefit in going IRB. This achieves one of the key principles that was set out by the PRA in *levelling the playing field* between IRB and SA firms.

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Buy-to-Let

The graphs to the right show the BTL RWs (performing only) split by LTV bands, as well as a comparison against SA RWs. This is a simplified comparison against the RWs for exposures ‘materially dependent on cashflows generated by the property’, and hence does not consider the four-property exemption proposed in CP16/22 (or other changes such as the use of origination valuations). However, we note that the exemption would likely further reduce the portfolio-weighted RW under the SA approach, where some exposures would fall within the ‘not materially dependent on cashflows’ asset class, which is subject to lower RWs.

The BTL portfolio level RW trends by LTV are broadly consistent with the performing-only RW trends shown, except for the >100% LTV band.

The higher IRB RWs for BTL are a result of a number of key model drivers which, due to a lack of historical data and challenges with data representativeness, have resulted in significant Margins of Conservatism being applied. This is particularly evident in the central tendency used in the PD backcast, as well as for LGD component estimates, where some firms have also incorporated the PRA’s reference points. Given the expectation to capture economic conditions equivalent to those observed during the early 1990s, and the maturity of the BTL market over the downturn period, the PRA has remained sceptical on the relevance of the observed data to firms’ current portfolios.

The analysis suggests that for higher LTV bands, the benefit of IRB has reduced. However, given the materiality of BTL portfolios in comparison to OO, as well as the typically lower LTV profile observed for BTL portfolios, a majority of firms still see a tangible benefit in maintaining IRB models across retail mortgage exposures.

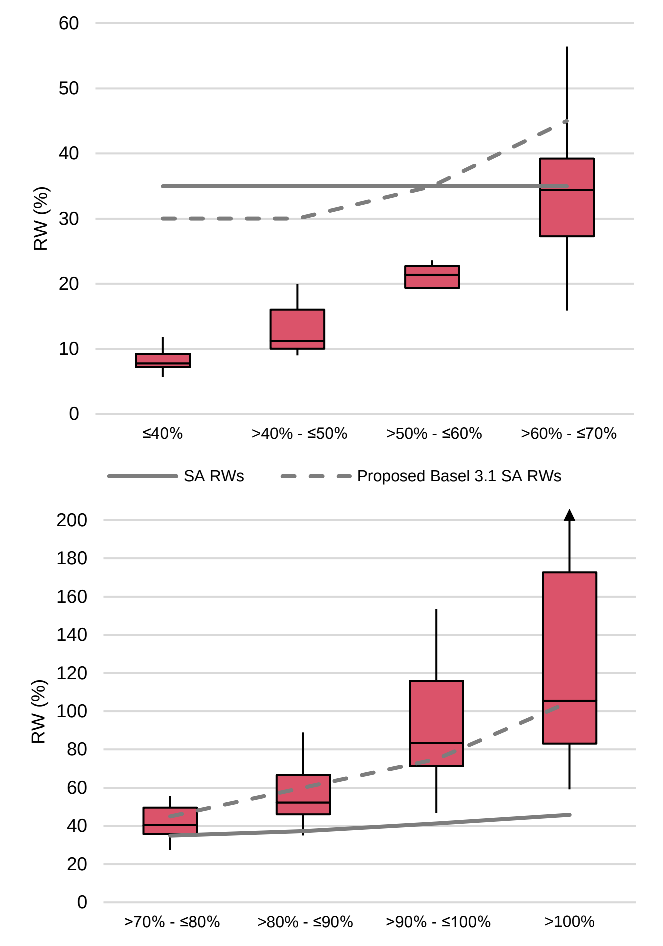

Figure 3. BTL performing RWs by LTV band

How can we help?

We have strong practical experience in supporting UK banks and building societies in their ongoing IRB submissions and remediation activities. Our team continues to work with firms to assess IRB RWs to ensure these appropriately reflect their risk appetite, whilst remaining aligned to regulatory expectations. This includes:

- Sharing **insights on IRB RW outputs** and assessing the **appropriateness of conservatism** across model components
- Providing **Board and senior management comfort** over the **plausibility** of the **submission** by assessing compliance against regulatory requirements
- Providing **independent insights** into the **latest regulatory expectations** to **better prepare** for any **potential regulatory challenge,** especially on contentious matters that may materially drive RWAs

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