Financial Services Regulatory Insights

PRA consults on UK standards on economic downturn for IRB models

AT A GLANCE

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What's new?

- The Prudential Regulation Authority (PRA) published a consultation paper (CP) "Credit risk: The identification of the nature, severity, and duration of an economic downturn for the purposes of Internal Ratings Based (IRB) models" on 7 April 2021.
- The CP sets out the PRA's proposed requirements on downturn identification for Loss Given Default (LGD) and Exposure at Default (EAD) IRB models across exposure classes, as well as a number of other minor amendments to the PRA's IRB Supervisory Statement (SS) 11/13 in response to the UK's withdrawal from the European Union (EU).
- Firms will be required to comply with the proposals from 1 January 2022, in line with the implementation dates set out in the PRA's Policy Statement (PS) 11/20.

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What does this mean?

- The European Banking Authority (EBA) previously published final draft Regulatory Technical Standards (RTS) on downturn identification in 2018 (EBA/RTS/ 2018/04). The PRA had indicated its intent to apply these RTS from January 2022, including in the PS11/20 published in May 2020.
- However, given the EBA RTS had not been finalised by the end of the transition period following the UK's withdrawal from the EU, they do not automatically apply. Therefore, should the PRA wish to implement the RTS, it needs to incorporate them within the UK regulatory framework.
- The CP is generally aligned to the EBA's RTS, including the proposed European Commission (EC) amendments, with a range of drafting changes which provide flexibility on a number of areas and formally adopt the proportionality component.

Nature of economic downturn

- Both the general and exposure class-specific economic factors (termed 'economic indicator set' by the PRA) that must be considered by firms remain consistent with those defined by EBA RTS.
- Where an economic indicator reflects a geographical distribution, the PRA requires this to be included once for each jurisdiction and, where appropriate, for *each geographical area within a jurisdiction*, covered by a material section of the exposure type. The requirement to consider geography at a more granular level than jurisdiction (where appropriate) is consistent with the EC's proposed amendments to the EBA RTS and may have implications for certain economic factors which differ at regional level within the UK.
- Consistent with the EC's draft, the PRA has proposed including a proportionality provision under which only economic indicators available *without incurring disproportionate costs* are required to be considered.

Severity of an economic downturn

- The PRA proposes that firms must consider a period of at least 20 years when assessing the most severe values of economic indicators.
- The EBA proposed that less than 20 years may be used specifically where an economic factor was subject to structural change due to a country's ascension to the EU.

- However, the PRA believes that permitting a shorter period under any circumstances would potentially lead to not identifying a sufficiently severe downturn period (termed 'applicable time-span' by the PRA).
- In practice, the requirement to consider economic indicators over at least 20 years is not expected to have a significant impact for mortgage exposures given current practices. However, there may be data availability challenges for other portfolios and exposure classes.

Duration of an economic downturn

- The PRA specifies that the duration of an economic downturn should be long enough to cover all peaks/ troughs related to the most severe 12-month values of the economic indicators. This is consistent with the EBA, but unlike the EBA, the PRA does not explicitly specify a minimum duration of 12 months. However, in practice we understand that the expectations remain unchanged.
- The PRA has also been less prescriptive over the extension of downturn periods to capture peaks/ troughs of indicators. In particular, the PRA has not introduced a requirement for economic indicators to be 'significantly correlated' when deciding to combine peaks/ troughs. The PRA has additionally declined to formalise expectations for the use of lags under a component-based LGD approach.

Other changes to SS11/13

- A number of other minor amendments to SS11/13 have been proposed as part of the CP.
- These primarily relate to the removal of references to EBA requirements and processes.
- Consistent with its recent statement in February, the PRA has proposed removing the requirement to comply with the EBA RTS on supervisory slotting approaches for specialised lending. An overarching comment has also been added to confirm EBA guidelines referenced in SS11/13 refer to versions as at the end of the transition period.
- References to the joint decision process between the PRA and other European Economic Area (EEA) regulators, EEA parents or consolidation groups have also been removed or updated.
- The individual required to make the annual IRB attestation has also changed from someone in a Significant Influence Function (SIF) role to one in a Senior Management Function (SMF) role, reflecting more recent PRA terminology.

What do firms need to do?

- Firms should assess whether models that have been developed to comply with the EBA RTS would be fully compliant with the newly proposed PRA requirements (including slotting approaches).
- Firms should continue to be in touch with their PRA supervisors regarding the impact of these proposals on recent and upcoming IRB model submissions and approvals.

Next steps

- The draft UK Technical Standards and amendments to SS11/13 will be subject to a consultation period **until 7 July 2021.** After this time, changes may be made to the requirements before becoming policy.
- Updates will be made to SS11/13 and firms will need to comply with revised requirements from **1 January 2022.**

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