BANK OF ENGLAND
PRUDENTIAL REGULATION AUTHORITY

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Policy Statement | PS13/21

Credit risk: The approach to overseas Internal Ratings Based (IRB) models

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1 Overview

1.1 This Prudential Regulation Authority (PRA) Policy Statement (PS) provides feedback to responses to Consultation Paper (CP) 16/20 'Credit Risk: The approach to overseas Internal Ratings Based (IRB) models'.[1] It also contains the PRA's final policy, as follows:

- an updated Supervisory Statement (SS) 11/13 'Internal Ratings Based (IRB) approaches' (Appendix 1); and[2]
- an updated pro-forma for firms to complete and submit to the PRA for overseas models moving onto the overseas models approach (Appendix 2).

1.2 This PS is relevant to UK banks, building societies, and PRA-designated investment firms.

Background

1.3 In a small number of cases, and provided relevant criteria are met, the PRA currently permits the solo capital requirements generated by non-European Economic Area (EEA) IRB models, typically developed to meet non-EEA IRB requirements, to be included in firms' UK consolidated capital requirements.

1.4 These overseas models may not be fully compliant with all relevant UK IRB requirements as they are designed to comply with non-UK IRB requirements, although the PRA has set criteria that seek to ensure a prudent approach.

1.5 In CP16/20, the PRA proposed clarifications to its approach to overseas models built to non-UK requirements, because:

- the UK had departed the European Union (EU) and the 'joint decision' framework for approving models in the EEA no longer applies;
- the PRA has observed challenges and concerns with allowing the use of overseas models in some instances;
- the PRA is aware that there may be further growth in use of overseas IRB models built to non-UK requirements in the future, as more firms are granted IRB permissions and expand overseas; and
- without a clear PRA framework for overseas models, firms may need to develop two sets of models to different requirements for the same exposures. The PRA considers that this could be an inefficient use of firm resources if there is only a minor difference in requirements that does not result in a materially different prudential outcome.

1.6 In CP16/20, the PRA proposed to:

1 October 2020 https://www.bankofengland.co.uk/prudential-regulation/publication/2020/credit-risk-the-approach-to-overseas-internal-ratings-based-models.

2 December 2013: https://www.bankofengland.co.uk/prudential-regulation/publication/2013/internal-ratings-based-approaches-ss.

- update its approach to overseas IRB models; and
- set additional criteria for use of the approach.

1.7 This updated approach will be referred to as the Overseas Models Approach (OMA).

Summary of responses

1.8 The PRA received three responses to the CP. Respondents generally supported the PRA's proposals. Some responses outlined specific concerns and requested further clarification. Specific areas where the PRA has amended or clarified the proposals are detailed in Chapter 2.

1.9 The PRA considers the main issues raised during the consultation relate to:

(i) the aggregate amount of credit risk risk-weighted assets (RWAs) derived using overseas models and the aggregate amount of exposure value allowed on the OMA;

(ii) the scope of jurisdictions eligible for the OMA; and

(iii) the scope of asset classes eligible for the OMA.

Changes to draft policy

1.10 Three changes have been made to the draft amendments to SS11/13 in light of the responses received. These are:

- the aggregate amount of credit risk RWAs derived using overseas models, and aggregate amount of exposure value allowed on the OMA, has been increased from 5% to 7.5%;
- the scope of asset classes eligible for the OMA has been expanded to include corporate small and medium-sized enterprises (SMEs); and
- a definition of the overseas models' exposure value measure has been introduced.

1.11 The PRA considers that the changes to the draft amendments to SS11/13 are not expected to have a significant cost impact on firms currently allowed to use overseas models in UK consolidated capital requirements, and will not materially alter the benefits of the policy or the cost benefit analysis presented in the CP.

1.12 The PRA considers these changes to be consistent with maintaining firm safety and soundness. The first two changes expand the scope of OMA, and the PRA considers that these changes will reduce the burden of modelling for firms without material impact on the maintenance of strong prudential standards. The third change clarifies the definition of 'exposure value', which should result in a consistent definition being used.

1.13 The PRA does not consider that the impact of the final updated SS11/13 will have a significantly different impact on mutuals relative to the impact of the draft in SS11/13, or to the impact of the final updated SS11/13 on other PRA-authorised firms.

Implementation

1.14 For existing overseas IRB models built to non-UK requirements that are not currently used for UK consolidated capital requirements, there are two options:

(i) firms that wish to use the OMA can now submit applications using the updated pro forma on the PRA's website. The implementation date for the changes resulting from this PS begins Thursday 1 July 2021; or

(ii) firms that do not wish to use the OMA can continue not to use it for UK consolidated capital requirements.

1.15 For existing overseas IRB models built to non-UK requirements that are already used for UK consolidated capital requirements, there are three options:

(i) if these models meet the new OMA criteria, they can continue to be used for UK consolidated capital requirements. Firms should submit a self-attestation that the criteria are met;

(ii) if these models do not meet the OMA's criteria from Thursday 1 July 2021, firms may need to remediate these models in order to meet UK IRB requirements or the criteria for the OMA. The PRA expects those models that do not meet the criteria to be remediated by Sunday 1 January 2023; or

(iii) if firms do not wish to use these models on the OMA, they will need to develop models that meet UK IRB requirements and discuss this with their supervisor.

1.16 The proposals set out in this PS have been designed in the context of the UK having left the EU and the transition period having come to an end. Unless otherwise stated, any references to EU or EU derived legislation refer to the version of that legislation which forms part of retained EU law.[3] The PRA will keep the policy under review to assess whether any changes would be required due to changes in the UK regulatory framework.

3 For further information, please see https://www.bankofengland.co.uk/eu-withdrawal/transitioning-to-post-exit-rules-and-standards.

2 Feedback to responses

2.1 The PRA must consider representations that are made to it in accordance with its duty to consult on its general policies and practices and must publish, in such manner as it sees fit, responses to the representations.

2.2 The PRA has considered the responses received to the CP. This chapter sets out the PRA's feedback to those responses, and its final decisions. The consultation responses have been grouped as follows:

- the aggregate amount of overseas models' credit risk RWAs and aggregate amount of overseas models' exposure value allowed on the OMA;
- the scope of jurisdictions eligible for the OMA;
- the scope of asset classes eligible for the OMA; and
- other responses.

The aggregate amount of overseas models' credit risk RWAs and aggregate amount of overseas models' exposure value allowed on the OMA

2.3 In CP16/20, the PRA proposed that aggregate overseas models' RWAs calculated using overseas models built to non-UK requirements make up no more than 5% of total group credit risk RWAs and the aggregate overseas models' exposure value makes up no more than 5% of the total group exposure value.

2.4 The PRA received three responses to this proposal. Respondents proposed increasing both limits to 15% to be in line with the permanent partial use measure in paragraph 6.5 of SS11/13. Respondents indicated that increasing the limits would give sufficient headroom for capital planning purposes at local and group level.

2.5 The PRA considers that increasing the limits by a factor of 3, to 15%, would create excessive prudential risk as these models could diverge materially from UK IRB standards, which could undermine the PRA's safety and soundness objective. However, the PRA recognises that the 5% limits may not give sufficient headroom for capital planning purposes. Increasing both limits is consistent with the PRA's secondary competition objective as it increases the extent to which UK firms can compete on a level playing field with local firms in relevant overseas jurisdictions. The PRA is therefore increasing both the RWA and exposure limits to 7.5%. The PRA considers the increase to be within its risk appetite and provide firms sufficient headroom for IRB models that may come onto the OMA, including as a result of the UK leaving the EU. In addition, this will reduce the burden of modelling for firms, without creating excessive prudential risk. As a result of the responses, the PRA has updated the SS amendments to reflect the increase in these limits.

The scope of jurisdictions eligible for the OMA

2.6 In CP16/20, the PRA proposed that the overseas models' scope would be limited to exposures that are located within a subsidiary in an equivalent jurisdiction (as determined under the Capital Requirements Regulation (CRR) Article 142(2)), where the model has been reviewed and approved by the overseas regulator, and the model is used to calculate local capital requirements in that jurisdiction. Firms would not be able to use the OMA for models in subsidiaries in non-equivalent jurisdictions.

2.7 The PRA received three responses to this proposal. Respondents proposed expanding the scope of eligible jurisdictions to include:

(i) on a case-by-case basis, jurisdictions where there has been no equivalence determination; and

(ii) models approved both by a regulator in an equivalent jurisdiction and by a regulator in a non-equivalent jurisdiction.

2.8 For (i), this would require the PRA to rely on the prudential framework of another country that has not been found to be equivalent. The PRA considers this would pose a potential threat to firms' safety and soundness.

2.9 For (ii), equivalent jurisdictions may take a variety of approaches for the review and joint approval of overseas models built to non-equivalent standards. If allowed, this approach may result in models on the OMA that have not had a full review by the equivalent jurisdiction and/or have not been designed to fully meet an equivalent jurisdiction's standards. This could result in models built to imprudent standards being used for UK consolidated capital requirements, potentially posing a significant risk to firms' safety and soundness.

2.10 The PRA has decided to retain the proposed policy for the scope of eligible jurisdictions. This is because equivalent jurisdictions can be expected to have similar standards for IRB modelling and similar standards of supervision to the PRA, resulting in broadly similar prudential outcomes. Models held to standards that are not judged equivalent could deliver weaker prudential outcomes and threaten a firm's safety and soundness.

2.11 The PRA clarifies that this does not preclude the use of the OMA for overseas models in equivalent jurisdictions that include exposures where the counterparty or security is located in a non-equivalent jurisdiction.

The scope of asset classes eligible for the OMA

2.12 In CP16/20, the PRA proposed that the overseas models' scope should only include exposures that are in the retail exposure class, including retail small and medium-sized enterprises (SME) exposures.

2.13 The PRA received three responses to this proposal. Respondents proposed expanding the scope of eligible assets to include corporate SMEs and mid-sized corporates, suggesting that a model's scope can include both retail and corporate SME exposures.

2.14 The PRA has decided to expand the criterion to include corporate SMEs, as these exposures are often modelled together with retail SMEs on a country-specific basis. The PRA considers that it could be unduly burdensome to require firms to split SME models into separate retail and corporate SME models in order to apply this approach, and that doing so would provide little prudential benefit. As a result of the responses, the PRA has updated the SS amendments to reflect the inclusion of corporate SMEs.

2.15 The PRA has decided not to expand the criterion to include mid-sized corporates. While the PRA recognises mid-sized corporates are typically less globally homogenous than large corporates, they are typically modelled separately from SMEs and are often modelled on a multi-country basis internationally. In this case, the PRA considers there to be limited prudential rationale to allow non-UK standards for calculating UK consolidated capital requirements.

Other responses

2.16 Two respondents asked whether their firms will be able to simultaneously submit overseas model applications to the local regulator and to the PRA. The PRA can confirm that firms can submit applications simultaneously; however, it will only grant permission once it is satisfied that the criteria for using the OMA are met. For the avoidance of doubt, and consistent with the current approach to overseas models, the PRA requires firms to categorise and submit to the PRA model change applications according to the Regulatory Technical Standards (RTS) for assessing the materiality of extensions and changes of the IRB Approach and the Advanced Measurement Approach (Regulation (EU) No 529/2014).

2.17 One respondent asked how often firms should monitor compliance with the OMA RWA and exposure criteria. They suggested that they are reviewed every three years. The PRA considers firms should regularly monitor their overseas model materiality, and alert their supervisors of any breach or likelihood of a future breach, in the same way that they would for other regulatory limits and measures. In order to facilitate the PRA's effective supervision of the OMA, the PRA expects that firms identify portfolios that are subject to the OMA as part of annual IRB model attestation. The PRA will observe the size and types of models using the OMA and decide whether any future refinements to the policy are necessary.

2.18 One respondent asked for clarification on the approach to models coming onto the OMA from Thursday 1 July 2021 that are currently scheduled for the European Banking Authority (EBA) IRB roadmap review. The PRA is not currently prioritising reviews of EBA roadmap changes for models that are expected to move to the OMA when this policy takes effect. Affected firms should confirm relevant model submission dates with their supervisors.

2.19 One respondent asked for clarification on when the submission and PRA review is expected for legacy non-mortgage overseas models that are no longer eligible under the OMA criteria and need to be redeveloped to PRA standards. Legacy non-mortgage overseas models will not be included in the current EBA IRB roadmap review programme, given that the implementation deadline is Sunday 1 January 2023. Affected firms should confirm relevant model submission dates with their supervisor.

2.20 One respondent commented that if the RWA or exposure measures are breached, it is unclear how long firms will have to then develop a PRA standards-compliant model. They also asked what timeframe will be provided for model re-development and PRA approval. The PRA considers that this will vary on a case-by-case basis and it will depend on the size of the breach, the reason for the breach, other regulatory changes and resourcing. Firms should notify the PRA of any breach, and present the PRA with a CRR Article 146 remediation plan for timely return to compliance if the effect of non-compliance is material.

2.21 One respondent asked for clarification of how to calculate the denominator of the exposure measure for the purpose of applying the OMA. Having considered this response, the PRA can confirm that exposure value and credit risk RWAs should be calculated according to the 'Part 3, Title II Capital Requirements for Credit Risk' section of the CRR.

Appendices

1	**SS11/13 'Internal Ratings Based (IRB) approaches', available at: https://www.bankofengland.co.uk/prudential-regulation/publication/2013/internal-ratings-based-approaches-ss.**
2	**Updated pro-forma, available at: https://www.bankofengland.co.uk/prudential-regulation/authorisations/capital-requirements-regulation-permissions.**