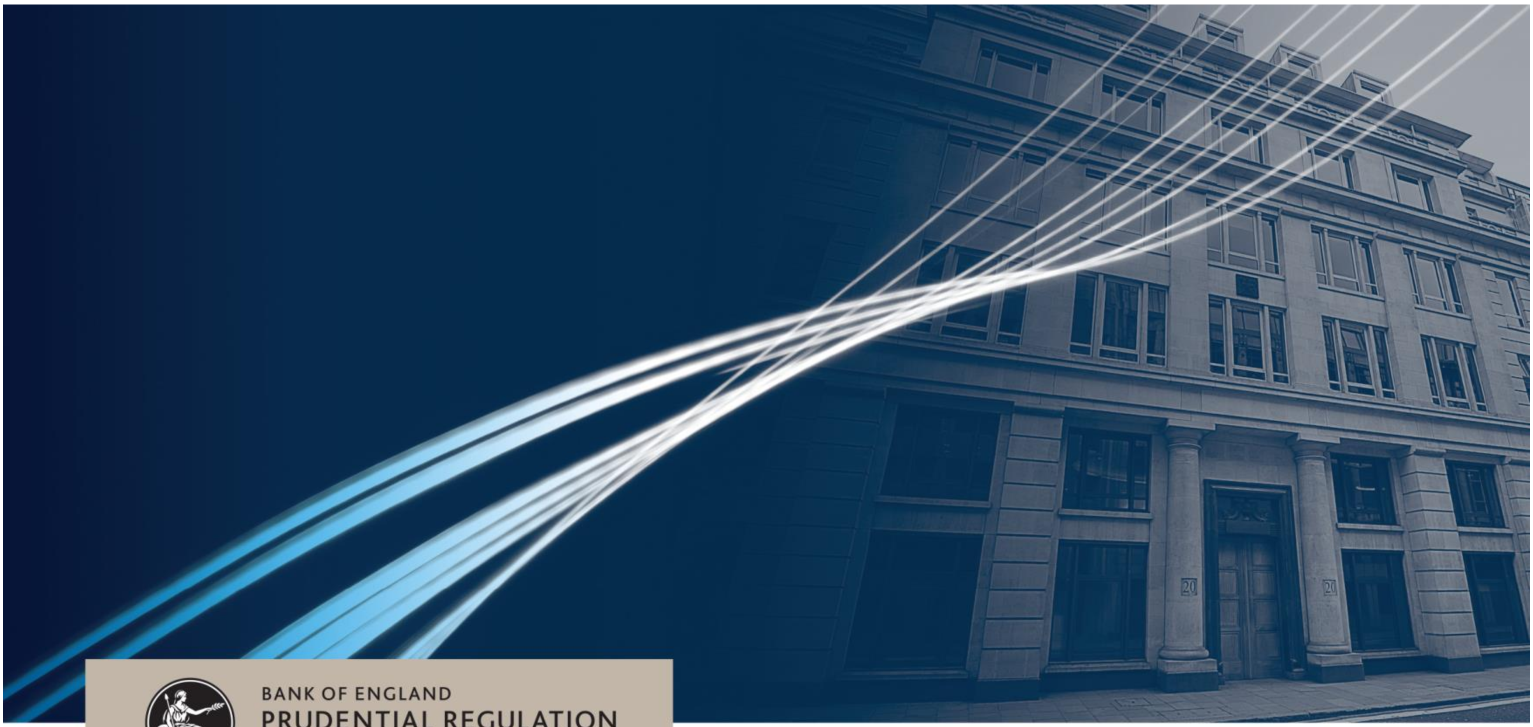

BANK OF ENGLAND
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Consultation Paper | CP14/20

Internal Ratings Based UK mortgage risk weights: Managing deficiencies in model risk capture

30 September 2020

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Responses are requested by 30 January 2021.

In light of current measures to help prevent the spread of Covid-19, please address any comments or enquiries by email to: CP14_20@bankofengland.co.uk

Alternatively, please address any comments or enquiries to:
Credit and Operational Risk Team
Prudential Regulation Authority
20 Moorgate
London
EC2R 6DA

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1 Overview

1.1 This Consultation Paper (CP) sets out the Prudential Regulation Authority's (PRA) proposals to introduce new expectations on Internal Ratings Based (IRB) UK mortgage risk weights.

1.2 The proposals in this CP would result in changes to Supervisory Statement (SS) 11/13 'Internal Ratings Based (IRB) approaches' (Appendix 1).

1.3 This CP is relevant to PRA-authorised UK banks, building societies and ring-fenced banks (RFBs) holding IRB model permissions. It may be of interest to other firms, including those considering applying for IRB model permission, and other market participants.

1.4 The purpose of these proposals is to address the prudential risks stemming from inappropriately low IRB UK mortgage risk weights. An additional benefit from these proposals would be a narrowing of differentials between IRB and standardised approach (SA) UK mortgage risk weights, and a limit on future divergence. The PRA considers that this would support competition between firms on the different approaches.

1.5 The PRA does not expect these proposals to result in significant implementation costs. For those firms whose risk weights may increase as a result of these proposals, and where capital requirements are not already determined by other capital measures (eg leverage), there would be costs for the firm associated with the additional capital required.

Background

1.6 Risk weighting is a key part of the UK's capital framework. A number of typically larger UK firms use IRB models when calculating their risk weights as inputs to risk weighted capital requirements and ratios.

1.7 The average IRB UK mortgage risk weight is just under 10%, having fallen from c.13% in 2014. These are historically low average IRB UK risk weights.[1] This average conceals significant firm variation in IRB risk weights, which range from c.4% to c. 17%. Even for the same loan quality, as measured by a given loan-to-value (LTV) bucket, different models currently give very different risk weights. Some individual IRB mortgage risk weights, particularly for low LTVs, are much lower.

1.8 By comparison, the lowest SA UK mortgage risk weight is 35%, while the EU average IRB mortgage risk weight is c. 13%.[2]

1.9 The fall to relatively low mortgage risk weight levels in the UK reflects, to some extent, improvements in the wider UK economy and increases in average UK house prices in the five year period between 2014 and 2019. However, all risk weight modelling contains a level of uncertainty. The degree of uncertainty is largest where there are fewer observed data and less historical experience. While mortgage books contain significant numbers of individual loans, there is limited data relating to tail risk events which could lead to significant increases in arrears, defaults and

1 As of end 2019. Figures used and quoted in this paper pre-date the UK's response to Covid-19, unless specifically stated otherwise.

2 These concerns, which the PRA has had for some time, were first discussed by Sam Woods in his speech to the Building Society Association on 24 May 2019: https://www.bis.org/review/r190524d.pdf , and reiterated by Sarah Breeden in her speech 'Climbing Mountains Safety on 22 July 2020: https://www.bankofengland.co.uk/-/media/boe/files/speech/2020/climbing-mountains-safely-speech-by-sarah-breeden.pdf?la=en&hash=CF73F9B89A0EAD9558975097AA5B1D5BED16F610 .

losses, even at lower LTVs. Given the inherent uncertainty, the PRA is concerned that some IRB UK mortgage risk weights may not fully reflect the potential for losses in unlikely, but possible, tail scenarios. As a result, some IRB mortgage risk weights may not fully capture risks, and therefore could be inappropriately low.

1.10 There can also be large differences between SA and IRB mortgage risk weights. Where such differences are unwarranted, this can distort competition. Reducing unwarranted difference would advance the PRA's secondary competition objective by:

- reducing the difference in SA and IRB mortgage risk weights for current UK mortgages;
- placing a limit on future divergence, and;
- reducing the variability of mortgage risk weights between those firms on the IRB approach for given levels of mortgage LTVs.

1.11 The PRA has recently consulted on, and finalised changes, to the IRB approach relating to definition of default, probability of default (PD) and loss given default (LGD) estimation.[3] It has also introduced the 'hybrid approach'.[4] Other changes to the IRB approach and SA are pending following the finalisation of the post-crisis Basel III reforms.[5] These reforms will reduce excessive variability of firms' risk weighted assets, and in doing so make risk-based capital ratios more transparent and comparable.

1.12 Together, these incoming reforms are likely to reduce cyclicality and variability across firms. In doing so, they are likely to lead to an increase in some of the lowest IRB risk weights. The extent to which this is the case however remains uncertain. Moreover, these reforms are not targeted at the full range of concerns with UK IRB mortgage risk weights. The risk remains that some IRB mortgage risk weights will continue to be inappropriately low, deficient in risk capture, and not sufficiently comparable. In order to be as fully informed as possible, the PRA is requesting data from firms as part of this consultation.

1.13 The PRA is therefore proposing its own measures to address these prudential risks by proposing expectations for IRB UK mortgage risk weights. This follows an extensive period of analysis by the PRA on the reasons for, and potential consequences of, falling IRB risk weights. The PRA considers the proposals as additional measures to ensure the robustness of the IRB framework. These proposals may not be relevant for all IRB firms, particularly after other IRB reforms have taken place, but they would reduce the risk of IRB UK mortgage risk weights falling further in the medium to long term. Other countries including Norway, Finland, Sweden, Belgium and the Netherlands have all introduced measures to address low IRB mortgage risk weights.

1.14 The PRA recognises that the leverage ratio may mitigate some of the risks identified. The leverage ratio is a complement, at an aggregate level, to the risk-weighted asset ratio. The leverage ratio therefore acts as a broad guardrail against aggregate deficiencies in the risk weight framework. Because of its broad design, however, it cannot address significant known shortcomings of specific

3 On the definition of default, March 2019: https://www.bankofengland.co.uk/-/media/boe/files/prudential-regulation/policy-statement/2019/ps719 ; for PD and LGD estimation https://www.bankofengland.co.uk/-/media/boe/files/prudential-regulation/policy-statement/2020/ps1120.pdf.

4 June 2017: https://www.bankofengland.co.uk/-/media/boe/files/prudential-regulation/policy-statement/2017/ps1317.pdf .

5 December 2017: https://www.bis.org/bcbs/publ/d424.pdf.

elements of the risk weight framework. For example, the leverage ratio would not mitigate the risks identified above for some firms who balance inappropriately low IRB mortgage risk weights with products that have higher risk weights. The PRA considers that residential mortgages form such a substantial asset class that the leverage ratio is not an adequate substitute for ensuring the risk weight framework itself captures specific deficiencies in risk capture.

1.15 The 'output floor', as introduced under the finalised Basel III post-crisis reforms, may also mitigate some of the observed risks.[6] However, it is a total balance sheet wide measure, and not designed to specifically address shortcomings with IRB mortgage risk weights in the UK. Similar to the leverage ratio, it would not mitigate risks when inappropriately low IRB mortgage risk weights off-set against products with higher risk weights. Moreover, under the implementation timeline agreed by the Basel Committee on Banking Supervision, the output floor is not due to be fully phased in until 2028.

Implementation

1.16 The PRA proposes that the final policy resulting from this CP would take effect from Saturday 1 January 2022 alongside other IRB reforms.

Responses and next steps

1.17 This consultation closes on Saturday 30 January 2021. The PRA invites feedback on the proposals set out in this CP. Please address any comments or enquiries to CP14_20@bankofengland.co.uk.

1.18 The PRA also encourages IRB firms to complete Appendix 2 as part of their feedback. Any data that the PRA receives as part of this consultation will help inform the PRA's final proposals.

1.19 The proposals set out in this CP have been designed in the context of the UK's withdrawal from the European Union and entry into the transition period, during which time the UK remains subject to European law. The PRA will keep the policy under review to assess whether any changes would be required due to changes to the UK regulatory framework at the end of the transition period, including those arising once any new arrangements with the European Union take effect.

1.20 The PRA has assessed that the proposals would not need to be amended under the EU (Withdrawal) Act 2018 (EUWA) at the end of the transition period. Please see PS5/19 'The Bank of England's amendments to financial services legislation under the European Union (Withdrawal) Act 2018' for further details.[7]

6 The 'output floor', when fully phased in, will ensure that IRB firms' risk weights do not fall below 72.5% of those derived under standardised approaches. December 2017: https://www.bis.org/bcbs/publ/d424.pdf.

7 April 2019: https://www.bankofengland.co.uk/paper/2019/the-boes-amendments-to-financial-services-legislation-under-the-eu-withdrawal-act-2018.

2 Proposals

2.1 The PRA proposes to introduce two complementary expectations on the level of IRB UK mortgage risk weights. The PRA considers models delivering risk weights below these levels are likely to be materially deficient in risk capture:

(i) a risk weight of at least 7% for each individual UK residential mortgage exposure; and

(ii) an exposure-weighted average risk weight of at least 10% for all UK residential mortgage exposures to which a firm applies the IRB approach.

2.2 Both proposals would apply at all levels of consolidation, and cover all UK residential mortgage exposures.

2.3 Assigning risk weights to assets is a crucial part of the prudential capital framework. It is imperative that risk weights are calculated and set prudently to ensure individual firms have sufficient capital for the risks they are exposed to, and to ensure confidence in the risk weight framework itself.

2.4 Residential mortgages represent the largest single asset class held by UK firms and form a material part of many UK firms' balance sheets. The consequences of imprudent risk weights for UK mortgages are therefore particularly high. Undercapitalisation puts individual firms' safety and soundness, and therefore UK financial stability, at risk.

2.5 Calculating IRB mortgage risk weights is inherently uncertain. Following detailed analysis over recent years, the PRA has identified the following particular areas of concern:

- there is large variation in IRB risk weights between firms, particularly for low LTV mortgages, including variation between loans with similar LTVs;

- average UK IRB mortgage risk weights, including at low LTVs, are below – and in some cases significantly below – international peers. The PRA notes that a number of other jurisdictions, including those in the EU, have acted to address low risk weights generated from some IRB models;

- risk weights for low LTV mortgages can be difficult to calibrate due to limited historical experiences of either extreme house price falls or the varying effects different types of economic downturn might have. This uncertainty increases with fewer observed defaults. There are clear prudential risks stemming from very low risk-weighting (and consequential capitalisation) for such a material asset class if historical experience turns out to be a poor guide to the future;

- a minimum risk weight of 35% is currently applied to residential mortgages under the standardised approach (SA). This will reduce to 20% under the finalised Basel III post-crisis reforms for low LTV mortgages. Some IRB mortgage risk weights are significantly lower than this. The PRA considers that very significant divergence from the SA, for a given LTV, is likely unwarranted, and an indicator that some IRB risk weights may be inappropriately low. It is also likely to create a competitive imbalance between those firms using IRB models, and those on the SA; and

- IRB mortgage risk weights have been falling for a number of years and although it is unclear whether the trend will continue in the short term given the global pandemic, there remains the risk that the medium and longer term trend of falling mortgage risk weights will continue, increasing the likelihood that some IRB mortgage providers are undercapitalised.

2.6 Incoming policy measures such as the 'hybrid approach' and 'output floor' may partially address some of these concerns, to varying extents. However these risks will not be completely dealt with by the current suite of future policy measures as they are not targeted at the observed risks set out above

(i) Individual mortgage exposure risk weight of at least 7%

2.7 In order to specifically address the observed risks, the PRA proposes two new expectations. The first is targeted at individual UK mortgages, and would set an expectation that the IRB risk weight for a UK mortgage exposure should be at least 7%.

2.8 The PRA considers that all mortgage lending contains a minimum degree of risk that should be captured by firms' credit risk models. The proposed risk weight expectation is a simple, targeted, and efficient measure to encourage all IRB UK mortgage lending to be appropriately risk-weighted and capitalised, and would address any potential for deficiency in risk capture by IRB mortgage models.

2.9 In calibrating the proposed risk weight expectation, the PRA took a range of factors into account, including peer comparisons, idiosyncratic UK mortgage market risks, and comparison with the SA. A key intention of the proposed calibration of 7% is to ensure some capitalisation for relevant tail risk events, whilst still allowing for meaningful risk sensitivity between different lending.

2.10 Average UK mortgage risk weights are substantially lower than the average for the EU. Reasons for this include the different natures of UK and EU countries' domestic mortgage markets. The proposed calibration of a loan-level expectation of at least 7% moves UK and EU IRB average risk weights closer, while taking account of the specific nature of the UK mortgage market.

2.11 The finalised Basel III post-crisis reforms will introduce a minimum SA mortgage risk weight of 20%. The PRA acknowledges that firms' models may be able to discriminate risks well enough to support risk weights below this level. However, the PRA considers that risk weights significantly below one-third of this level are unlikely to be justified.

2.12 This calibration would likely lead to a relatively small increase in average UK mortgage risk weights, but is intended to prevent the lowest mortgage risk weights continuing their trend and falling significantly further. A small number of firms could see a more significant rise in capital requirements on certain mortgage exposures.

2.13 Overall, the PRA considers that models delivering very low UK mortgage risk weights are not adequately taking into account relevant tail-risk events, and are likely materially deficient in risk capture. Nevertheless, the PRA recognises the inherent uncertainty in calculating appropriate risk weights and welcomes feedback which may include relevant historical data or other evidence.

(ii) Exposure-weighted average risk weight of at least 10%

2.14 The PRA also proposes an exposure-weighted average risk weight of at least 10% for an IRB UK mortgage portfolio as a whole. All mortgage lending comes with a degree of risk. The PRA considers that, at a portfolio level, this proposal represents a minimum level below which an IRB mortgage model is likely to be materially deficient in risk capture.

2.15 While the individual loan level expectation may deliver much of the PRA's objective on its own, the PRA considers there is a risk that, over time, portfolio averages may continue to fall to inappropriately low levels. On its own, the individual loan level expectation may lead (or even encourage) a lack of risk differentiation. The PRA considers that this average portfolio expectation complements the proposed individual loan level expectation, and mitigates against portfolio averages (containing different UK mortgage exposures carrying different levels of risk) falling further in the medium to long term.

2.16 The PRA considers an additional average portfolio expectation, calibrated at a higher level than the loan-level proposal, to be a simple and targeted measure.

2.17 In calibrating this expectation at 10%, the PRA has taken similar factors and judgements into account for the proposed individual mortgage exposure expectation. In particular, current UK IRB mortgage risk weights are on average close to 10%. Given the risks identified, the PRA is proposing a portfolio average expectation of at least 10% to ensure that models are not materially deficient in risk capture, and to reduce the likelihood that average IRB mortgage risk weights fall further.

2.18 The PRA recognises that firms' IRB models and risk management practices can support risk-sensitive lending at lower risk weights than those set under the finalised Basel III post-crisis SA approach level of 20%. However, the PRA considers that average IRB UK mortgage lending should not fall below half of the lowest future individual SA mortgage risk weight (20%).

2.19 In analysing, developing and refining these proposals over the last few years, the PRA has carefully considered their interaction with other IRB reforms and wider regulatory changes, including the leverage ratio and the proposed output floor. The PRA welcomes feedback on the proposed loan-level and average floors individually and in combination with each other.

2.20 In considering the final calibration of the floors, the PRA will take into account any information firms can provide on the impact of the calibrations. The PRA encourages firms responding to this consultation to complete the table in Appendix 2. The upper part of the table will provide more accurate estimates of the impact for the loan level floor at a range of calibrations (including below 7%), and the whole table will provide more accurate estimates for both floors. Data the PRA receives as part of this consultation will help inform the final calibration of the PRA's proposals.

3 The PRA's duty to consult

3.1 The PRA has a statutory duty to consult when introducing new rules and, when not making rules, has a public law duty to consult widely where it would be fair to do so. When doing so, the PRA provides the following in relation to the proposed policy:

- a cost benefit analysis;
- an explanation of the PRA's reasons for believing that making the proposed policy is compatible with the PRA's duty to act in a way that advances its general objective, insurance objective (if applicable), and secondary competition objective;
- an explanation of the PRA's reasons for believing that making the proposed policy is compatible with its duty to have regard to the regulatory principles; and
- a statement as to whether the impact of the proposed policy will be significantly different to mutuals than to other persons.

3.2 The Prudential Regulation Committee (PRC) should have regard to aspects of the Government's economic policy as recommended by HM Treasury.[8]

3.3 The PRA is also required by the Equality Act 2010[9] to have due regard to the need to eliminate discrimination and to promote equality of opportunity in carrying out its policies, services and functions.

Cost benefit analysis

3.4 The proposals would help ensure IRB UK mortgage risk weights (and associated capital requirements) are not inappropriately low, and do not fall further. This would reduce the risk of disorderly firm failure. Reductions in the individual risk of disorderly failure and increased confidence in the integrity and robustness of the IRB regime and associated capitalisation of the UK mortgage market would also benefit financial stability. The proposals would also benefit competition between firms with different IRB models and between firms using IRB and those using the SA.

3.5 The proposed expectation of risk weights for UK mortgages of at least 7% would deliver a minimum level of capital for lower risk exposures where confidence in modelling is lowest, given the difficulty in differentiating risk for those exposures.

3.6 Despite relevant IRB reforms, IRB risk weights can be sensitive to house price changes over time. The proposed 10% average mortgage portfolio expectation would decrease sensitivity to house price rises and reduce the extent to which average mortgage risk weights might fall below their current levels, which an individual UK mortgage expectation of at least 7% might not achieve on its own.

3.7 The PRA recognises that the proposals may come with costs to some firms that use the IRB approach and have particularly low IRB risk weights. These costs arise from increases in risk weights and consequent increases in capital requirements. An expectation of risk weights of at least 7% would have an impact on those firms applying risk weights below this level to their UK mortgage

8 Section 30B of the Bank of England Act 1998.
9 Section 149.

exposures. Similarly, a portfolio-level risk weight expectation of at least 10% would impact those firms with average risk weights that remain below 10% after application of the individual risk weight proposal.

3.8 The impact of the proposed measures should be considered in conjunction with other policy changes that will impact IRB-derived mortgage risk weights including:

(i) the 'hybrid approach', which should reduce excess cyclicality in IRB models;[10]

(ii) the 'EBA roadmap for IRB', which should reduce unwarranted variability in IRB risk parameters; [11] and

(iii) the finalised Basel III post-crisis reforms, including the output floor.[12]

3.9 The PRA estimates that the direct costs of these proposals, in addition to the incoming policy changes, are not expected to be significant. The proposals are deliberately calibrated to deliver a slight rather than significant increase in current average risk weights (and therefore capital requirements) across all firms. As a result, a particular benefit of the proposals is that average IRB UK mortgage risk weights would not fall any further than their current level. However, the PRA recognises that while the overall average impact in the UK may be relatively low, individual firms with particularly low IRB UK mortgage risk weights may see larger increases as a result of these proposals.

3.10 Nevertheless, the exact impact of the incoming policy changes, and therefore these additional proposals, is uncertain. This is due to a lack of sufficiently granular data to assess the individual and combined impact of the future policy changes, alongside the proposals presented in this CP. The combination of impacts will also differ across firms depending on their respective starting points. Firms are encouraged to complete the data template in Appendix 2 as part of their responses, on a voluntary basis. Specifically, while the PRA has proposed a risk weight expectation of at least 7% for UK IRB mortgage risk weights, it is possible the optimum calibration to achieve the PRA's purposes would be slightly different once other incoming policy changes are taken into account. Any additional data firms provide in line with Appendix 2 will inform the PRA's final calibration.

3.11 The individual proposals are relatively simple so as to avoid adding undue complexity to the capital regime. However, the proposal to introduce expectations on both individual and portfolio risk weights does add greater complexity and cost than just one measure. The PRA considers the additional complexity to be low, and offset by the complementary nature and combined benefits of the two measures. An average portfolio expectation on its own could be subject to regulatory optimisation, and potentially encourage higher risk lending. The PRA welcomes feedback on the level of complexity.

3.12 Firms would incur operational costs to implement the proposals as they represent a change to current practice. However, the PRA does not expect the implementation costs of these proposals to be significant. Other policy proposals would already require firms to review their IRB approaches and

10 July 2016 and June 2017: https://www.bankofengland.co.uk/-/media/boe/files/prudential-regulation/consultation-paper/2016/cp2916 and https://www.bankofengland.co.uk/-/media/boe/files/prudential-regulation/policy-statement/2017/ps1317.pdf.

11 April 2019: https://www.bankofengland.co.uk/paper/2019/the-boes-amendments-to-financial-services-legislation-under-the-eu-withdrawal-act-2018.

12 December 2017: https://www.bis.org/bcbs/publ/d424.pdf.

models over the same time period. The PRA has sought to coordinate the implementation of these proposals with other changes to IRB models in order to keep implementation costs to a minimum.

3.13 Overall, the PRA considers the benefits of the proposals in this CP outweigh the costs.

Compatibility with the PRA's objectives

3.14 These proposals are intended to prevent IRB risk weights for UK mortgages, and related regulatory capital levels, being inappropriately low such that they constitute material deficiencies in capturing a firm's risks. This contributes to the PRA's objective of promoting the safety and soundness of firms. More generally these proposals support market confidence in the integrity of the IRB regime and benefit financial stability.

3.15 The proposals would also contribute to the PRA's secondary competition objective. Low IRB risk weights have been identified as a key source of competitive imbalance between large firms (that predominantly use the IRB approach) and smaller firms (typically on the SA). This is because, for the same mortgage, IRB risk weights can be many multiples lower than the equivalent SA risk weight, with a consequential capital impact.

3.16 As a result, the typically smaller lenders on the SA are at a competitive disadvantage to typically larger lenders with IRB model permission. This is particularly pertinent for lower-risk mortgage products, which carry a minimum risk weight of 35% under the SA. This means some SA lenders can be encouraged into higher-risk lending, but even in higher-risk market niches, some IRB mortgage risk weights may be lower than equivalent SA ones.

3.17 Together the proposed minimum expectations would facilitate competition in the UK mortgage market by partially addressing the large disparities in risk weights between IRB firms and SA firms, and between different IRB firms. Some IRB firms may have to increase the risk weight applied to UK mortgages, moving closer to the SA risk weight level. A linked benefit is that these proposals would limit the possibility for differences between IRB and SA UK mortgage risk weights widening in future.

3.18 These proposals aim to decrease disparities between firms and thus barriers to competition. Firms using the SA may be able to more effectively compete with firms with IRB model permissions for a wider variety of mortgage products and customers, increasing competition in the UK mortgage market.

Regulatory principles

3.19 These proposals follow an extensive period of PRA analysis. As part of their development, the PRA has had regard to the regulatory principles. Three principals are of particular relevance:

- that a burden or restriction should be proportionate to its benefits. The PRA has proposed a relatively simple approach in this CP to achieve its objectives. A more complex approach, for instance proposals which might require complex model changes, may not lead to significantly more benefits than those proposed;

- the desirability where appropriate of the PRA exercising its functions in a way that recognises differences in the nature of, and objectives of, businesses. The proposals are targeted specifically at firms applying the IRB approach, and will only affect those firms with inappropriately low UK mortgage risk weights and deficient model risk capture; and

- the need to use resources in the most efficient and economical way. The PRA considers the relatively simple nature of the proposals allows for their efficient and effective implementation and supervision.

Impact on mutuals

3.20 The proposals apply to mutuals and non-mutuals alike. However, the overall impact will be most pronounced for firms where mortgages are the predominant asset class. Individually and as a sector, mutuals provide a higher proportion of their total lending in the form of residential mortgages compared with the non-mutual sector.

3.21 The PRA notes that the majority of mutuals use the SA. The proposals will decrease barriers to competition for these mutuals, in the same manner as for other firms using the SA, by limiting the divergence between SA and IRB mortgage risk weights, and increasing their capacity to compete with firms on the IRB approach. Given mutuals' focus on mortgage lending, the comparative competition benefit mutuals may receive would be typically higher than those for non-mutuals.

3.22 Those mutuals on the IRB approach which may have risk weights lower than the proposed expectations, and are not bound by other capital measures, may see consequential rises in their risk weights and associated capital requirements, in the same manner as non-mutuals. As such mutuals would have less scope to diversify lending than non-mutuals, the impact of these proposals may be greater than comparative non-mutuals with similar IRB mortgage risk weights but with a more varied asset base.

HM Treasury recommendation letter

3.23 HM Treasury has made recommendations to the PRC about aspects of the Government's economic policy to which the PRC should have regard when considering how to advance the PRA's objectives and apply the regulatory principles.[13]

3.24 The aspects of the Government's economic policy most relevant to the proposals in this CP are:

- competition; and
- growth.

3.25 As set out under 'compatibility with the PRA's objectives' above, the PRA considers the proposals will enhance competition between firms using IRB and SA, and between firms with different models using IRB.

3.26 The PRA considers these measures will make UK IRB risk weights more robust and strengthen investor confidence in them. This is likely to improve market discipline, confidence and financial stability, all of which are essential prerequisites for strong, sustainable and balanced growth.

3.27 The PRA has also carefully considered whether the proposals are likely to have any detrimental impact on the overall growth of the UK mortgage market, particularly in the current economic environment. This has been particularly important when deciding the calibration of the proposed

[13] Information about the PRC and the recommendations from HM Treasury are available on the Bank's website at https://www.bankofengland.co.uk/about/people/prudential-regulation-committee .

two IRB expectations. The proposed expectations should not limit future growth. This is because the proposed amounts are not so high as to unduly restrict significant amounts of new lending. A key feature is that they may act to reduce IRB UK mortgage risk weights falling further in the medium to long term, and the competition benefits these proposals will bring may encourage additional growth and mortgage lending from SA firms.

Equality and diversity

3.28 The PRA considers that the proposals do not give rise to equality and diversity implications.

Appendices

Appendix 1: Draft amendments to SS 11/13 'Internal Ratings Based (IRB) approaches'

In this appendix, underlining indicates new text.

...

19 Notification and approval of changes to approved models

...

Adjustment to RWAs for UK Residential Mortgage Exposures in the Retail Exposure Class

19.19 The PRA expects models to be appropriately conservative and capture all relevant risks. Responsibility for ensuring this lies with firms.

19.20 It may be the case that some IRB mortgage models – despite receiving regulatory approval and otherwise complying with relevant regulatory standards – have material risk capture deficiencies resulting in inappropriately low modelled RWAs.

19.21 There may therefore be instances where it is prudent and correct for firms to adjust upwards the RWAs produced by their models on a permanent basis.

19.22 The PRA considers that models producing risk-weights lower than 7% for individual UK residential mortgage exposures are likely to be materially deficient in risk capture. The PRA therefore expects firms to increase those risk weights to at least 7% for each UK residential mortgage exposure.

19.23 Similarly, at a portfolio level, the PRA considers that models resulting in an exposure-weighted average portfolio risk-weight for UK residential mortgage exposures of less than 10% are likely to be materially deficient in risk capture. The PRA therefore expects firms to adjust the overall exposure-weighted average portfolio risk-weight to ensure it is at least 10%.

19.24 Firms may make post-model adjustments to meet these expectations.

19.25 Firms should include any RWA adjustments in their regulatory returns. In the FSA045 return the total RWA figure for each of the PD grades should reflect the 7% exposure-level risk-weight expectation. Relevant figures should be further increased where the portfolio level risk-weight expectation is applied.

Appendix 2: Data template response

Risk Weight Assigned (%) (All UK IRB mortgages)	Total RWAs (£mn, June 2020) *current policy/ regulation*	Exposure At Default (EAD) (£mn, June 2020) *current policy/ regulation*	Total RWAs (£mn, June 2020) estimated under hybrid approach and EBA roadmap	EAD (£mn, June 2020) estimated under hybrid approach and EBA roadmap	Total RWAs (£mn, June 2020) estimated under hybrid approach, EBA roadmap and Basel III finalisation	EAD (£mn, June 2020) estimated under hybrid approach, EBA roadmap and Basel III finalisation
0–1.99						
2–2.99						
3–3.99						
4–4.99						
5–5.99						
6–6.99						
7–7.99						
8–8.99						
9–9.99						
10–10.99						
11–11.99						
12–14.99						
15–19.99						
20—24.99						
25+						
RWA Average						

Guidelines for completing data template

1. Respondents are encouraged to complete this short table alongside any other comments they may have on the proposals outlined in this Consultation Paper. Responses are entirely on a voluntary basis.
2. The PRA recognises that completion may require a degree of estimation and judgement. Some regulatory policies are yet to be finalised, and some firms are yet to decide relevant individual implementation approaches.
3. If respondents make a particularly sensitive judgement, they are encouraged to explain what this was and why.
4. All fields in the table should be completed based on a June 2020 balance sheet and assume a consistent economic environment to provide useful comparative data. Should respondents already have similar estimates but based on other balance sheets (either historic or projected), a useful and pragmatic approach would be to provide that existing analysis, alongside an explanation of where the differences lie.

5. All UK residential mortgage exposures are in scope. Residential lending secured on property outside the UK is not included.

6. By 'hybrid approach' the PRA specifically means the policy set out in PS13/17 on residential mortgage risk weights.[14]

7. By 'EBA roadmap' the PRA specifically means the policy set out in PS7/19[15] on the definition of default and PS11/20[16] on PD and LGD estimation.

8. By Basel III finalisation, the PRA specifically means the finalisation of the Basel III post-crisis reforms published in 2017.[17] For the purposes of this exercise, the main relevant mortgage policy changes to take account of are:

   (a) removal of the 1.06 IRB scaling factor;

   (b) removal of the 10% exposure weighted average LGD floor;

   (c) introduction of a 5 basis point exposure level PD floor and a 5% exposure level LGD floor; and

   (d) not including the impact of the SA output floor, as this measure is only relevant to total balance sheets.

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14 June 2017: https://www.bankofengland.co.uk/prudential-regulation/publication/2016/residential-mortgage-risk-weights.
15 March 2019: https://www.bankofengland.co.uk/prudential-regulation/publication/2018/credit-risk-the-definition-of-default.
16 May 2020: https://www.bankofengland.co.uk/prudential-regulation/publication/2019/credit-risk-probability-of-default-and-loss-given-default-estimation.
17 Published by BIS: https://www.bis.org/bcbs/publ/d424.htm.