BANK OF ENGLAND
PRUDENTIAL REGULATION
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Policy Statement | PS23/21

Credit risk: The identification of the nature, severity, and duration of an economic downturn for the purposes of Internal Ratings Based (IRB) models

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Prudential Regulation Authority | 20 Moorgate | London EC2R 6DA

Contents

1 Overview

1.1 This Prudential Regulation Authority (PRA) Policy Statement (PS) provides feedback to responses to Consultation Paper (CP) 7/21 'Credit risk: The identification of the nature, severity, and duration of an economic downturn for the purposes of Internal Ratings Based (IRB) models'.[1] It also contains the PRA's final policy, as follows:

- a new UK Technical Standards Instrument (Appendix 1);
- an updated Supervisory Statement (SS) 11/13 'Internal Ratings Based (IRB) approaches' (Appendix 2); and[2]
- versions of the relevant European Banking Authority (EBA) Guidelines as they stood at the end of the transition period (Appendices 3–5).

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

Background

1.3 The PRA proposed in CP7/21 to:

- introduce requirements for identifying an economic downturn as UK Technical Standards;
- amend the related expectations in SS11/13; and
- make some additional minor changes to SS11/13, mainly to reflect the UK's withdrawal from the EU and the end of the transition period.

Summary of responses

1.4 The PRA received two responses to the CP. Respondents welcomed the PRA's proposal to introduce requirements for identifying an economic downturn as UK Technical Standards, as well as the related amendment to SS11/13. Respondents made a number of observations, and requests for clarification. Specific areas where the PRA has amended or clarified the proposals are detailed in Chapter 2. Respondents also welcomed the PRA's proposed minor changes to SS11/13 to reflect the UK's withdrawal from the EU and the end of the transition period. The PRA is implementing those changes without amendment.

1.5 The PRA considers that the main issues raised by respondents relate to:

1 April 2021: CP7/21 – Credit risk: The identification of the nature, severity, and duration of an economic downturn for the purposes of Internal Ratings Based (IRB) models.

2 July 2021: SS11/13 - Internal Ratings Based (IRB) approaches.

- whether only absolute levels of an economic indicator are relevant for identifying a downturn, or if the indicator's rate of change would also be relevant where appropriate; and

- a suggestion that the PRA provide detailed guidance on the meaning of 'shortly after' in the draft Standards Instrument. This is in relation to cases where firms can combine economic indicators' peaks or troughs into a single downturn period, when the peaks or troughs are reached 'shortly after' one another.

Changes to draft policy

1.6 Where the final Technical Standards differ from the draft in the CP in a way which is, in the opinion of the PRA, significant, the Financial Services and Markets Act 2000 (FSMA)[3] requires the PRA to publish:

(a) details of the difference together with a cost benefit analysis; and

(b) a statement setting out, in the PRA's opinion, whether or not the impact of the final Technical Standard on mutuals is significantly different to: the impact that the draft Technical Standard would have had on mutuals; or the impact that the final Technical Standard will have on other PRA-authorised firms.

1.7 The PRA has made changes to the draft Standards Instrument in light of the responses received. These amendments clarify that:

- in respect of the indicators specified in the Standards Instrument, firms must use levels, absolute changes in levels, or percentage changes of levels of economic indicators, depending on which gives the best indicator of economic conditions; but

- firms may additionally use other measures of those, or any other relevant indicators, where these are also explanatory variables for the economic cycle.

1.8 The PRA considers that these changes to the draft Standards Instrument will benefit firms by providing further clarification on the PRA's requirements on relevant economic indicators. The PRA considers the changes to be consistent with maintaining firm safety and soundness. These changes should promote consistency in firms' interpretations of requirements relating to the measurement of economic indicators, and promote consistency and comparability of IRB risk-weighted assets, contributing to strong prudential standards.

1.9 The PRA does not consider that the impact of the final UK Technical Standards Instrument will have a significantly different impact on mutuals relative to the impact of the draft UK Technical Standards Instrument, or on other PRA-authorised firms.

1.10 When making Technical Standards, the PRA is required to comply with several legal obligations, including publishing an explanation of the ways in which the PRA has had regard to these obligations and how they have affected the draft Standards Instrument. In CP7/21, the PRA set out this explanation in Chapter 4. The PRA considers that this takes into account responses to the CP, and there are no changes to the have regards analysis.[4]

3 Sections 138J(5), 138K(4) and 138S(2) of FSMA.
4 April 2021: CP7/21 – Credit risk: The identification of the nature, severity, and duration of an economic downturn for the purposes of Internal Ratings Based (IRB) models.

1.11 The PRA has considered the cost benefit impact of these changes relative to the draft policy. Due to the low materiality of the amendments to the draft Standards Instrument, the PRA considers that the cost benefit analysis presented in the CP remains relevant, and no further changes are necessary.

1.12 Alongside the changes to the draft Standards Instrument, the PRA has also introduced a new appendix to SS11/13. Appendix D provides a list of EBA Guidelines referenced in the Supervisory Statement with hyperlinks to the applicable versions as they stood at the end of the transition period following the UK's withdrawal from the EU. These can be found in Appendices 3–5.

1.13 The PRA has not made any changes to its proposal in CP7/21 that where SS11/13 refers to EBA Guidelines, these are to the versions as they stood at the end of the transition period following the UK's withdrawal from the EU. Therefore the inclusion of Appendix D does not result in any changes to the proposed policy, and no revision of the cost benefit analysis presented in the CP is necessary.

Implementation

1.14 The implementation date for the policy changes resulting from this PS will be Saturday 1 January 2022. This is in line with the implementation deadlines set out in PS11/20 'Credit risk: Probability of Default and Loss Given Default Estimation', for IRB firms to implement all changes from the IRB roadmap (except in respect of the Regulatory Technical Standards (RTS) on the materiality threshold for credit obligations past due under Article 178 of Regulation (EU) No 575/2013 for firms only using the standardised approach, where the implementation deadline was Thursday 31 December 2020).[5]

1.15 Firms should continue to submit model change applications in line with the submission timings communicated by their supervisors.

1.16 References related to the UK's membership of the EU in SS11/13 covered by the policy in this PS have been updated as part of this PS to reflect the UK's withdrawal from the EU. Unless otherwise stated, any remaining references to EU or EU-derived legislation refer to the version of that legislation which forms part of retained EU law.[6]

5 May 2020: Credit risk: Probability of Default and Loss Given Default estimation.
6 For further information please see Transitioning to post-exit rules and standards.

2 Feedback to responses

2.1 Before making any proposed Standards Instruments, the PRA is required by FSMA to have regard to any representations made to it, and to publish an account, in general terms, of those representations and its feedback to them.[7]

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 PRA has structured its feedback into four sections:

- the nature of economic downturns;
- the severity of an economic downturn;
- the duration of an economic downturn; and
- other responses.

The nature of economic downturns

2.3 Section 3 of the draft Standards Instrument provides a list of economic indicators the PRA would consider relevant for identifying an economic downturn. Paragraph 3.1, point (1), lists indicators that the PRA considers relevant for all exposures, such as gross domestic product (GDP), and the unemployment rate. Point (2) of the same paragraph then lists a set of indicators the PRA would consider relevant for specific portfolios, such as exposures to corporates or specialised lending exposures.

2.4 The PRA received two responses to this proposal. Respondents noted that Section 3 of the draft Standards Instrument is silent about whether only the indicator's absolute level would be relevant, or if its rate of change could, alternatively, be relevant in determining an economic downturn. Both respondents proposed that the PRA should amend the Standards Instrument to include some additional text to clarify this.

2.5 The PRA considers that relevant indicators can be reported in absolute levels, or as rates of change. For example, GDP is commonly reported as rates of change, but aggregate credit losses could be reported in absolute levels. The PRA considers that providing clarification on this issue would promote consistency in firms' modelling approaches.

2.6 The PRA has therefore amended the draft Standards Instrument to include a new paragraph 3.4. This new text confirms that levels, absolute changes in levels, or percentage changes of levels of economic indicators, should be used to identify an economic downturn as appropriate.

2.7 The PRA has also made a minor drafting amendment to paragraph 3.1, point 3. This is to allow firms to use more than one transformation of the same indicator for identifying downturns, where these are also explanatory variables for the economic cycle.

2.8 One respondent requested that the PRA indicates why it decided not to specify the types of economic indicators it will consider relevant when identifying an economic downturn. The PRA considers that both macroeconomic and credit related factors are relevant for identifying an economic downturn. However, the PRA considers that it has set out sufficient detail on the types of

7 Sections 138J(5), 138K(4) and 138S(2) of FSMA.

indicators that would be relevant in the standards instrument, and is therefore not making any further changes.

The severity of an economic downturn

2.9 In CP7/21, the PRA proposed that firms select a historical time-span which enables the identification of economic indicator values that represent 'sufficiently severe' downturn conditions. If the values do not represent 'sufficiently severe' downturn conditions, the PRA proposed to expect firms to extend their historical time-span beyond the minimum 20 year period. In this context, one respondent suggested the PRA could provide more guidance on the term 'sufficiently severe'.

2.10 In response, the PRA has made some minor drafting changes to paragraph 13.7A of SS11/13 to provide further clarity. The PRA considers that further detailed guidance on this is not necessary. The updated SS sets out the PRA's expectation that a firm should select a historical time-span that enables it to identify a 'sufficiently severe' downturn. This means it may be necessary for a firm to extend their historical time-span beyond 20 years.

The duration of an economic downturn

2.11 In CP7/21, the PRA proposed that an economic downturn should be indicated by the most severe value relating to an observed 12-month period for each relevant economic indicator. In this context, an economic downturn would be made up of one or more downturn periods, covering the peaks and troughs related to the most severe 12-month values for each relevant indicator. There may be cases where indicators' 12-month values peak or trough shortly after one another. To capture these cases, the PRA proposed to introduce a requirement in Section 2 of the Standards Instrument that firms should combine these downturns into a single downturn period.

2.12 One respondent requested that the PRA provide some further guidance on the term 'shortly after', as they considered its interpretation could be subjective.

2.13 The PRA considers that providing clarification on this point could lead to the requirements in Section 2 of the Standards Instrument becoming overly prescriptive. The PRA has therefore decided not to provide further guidance on 'shortly after'. This approach will give firms the flexibility to exercise their judgement on whether it would be appropriate to combine economic downturns.

2.14 In the context of identifying an economic downturn, one respondent requested clarification on whether the PRA intends that only a single downturn period should be identified, or whether institutions should identify all downturn periods and then estimate downturn loss given default (LGD) from the one that gives the most severe values. The PRA confirms that an economic downturn can comprise one or more downturn periods, as set out in paragraph 2.2(3) of the Standards Instrument. Where institutions identify multiple downturn periods, they should perform each of the steps outlined in Section 4, paragraph 15, of the EBA Final Report on the Guidelines for the estimation of LGD appropriate for an economic downturn ('Downturn LGD estimation').[8]

2.15 One respondent requested that the PRA clarify whether the identified downturn period should be a multiple of whole years (eg 1 year, 2 years, 3 years) or if it can be a multiple of months (eg 1 year 3 months, 2 year 5 months, 3 years 6 months). The PRA considers that the economic indicators listed as relevant in Section 3 of the Standards Instrument may not be reported annually in all cases. For example, some indicators relate to calendar years, but others could relate to financial quarters. The PRA confirms that the identified downturn period need not be a multiple of whole years.

8 March 2019: Final Report on the Guidelines for the estimation of LGD appropriate for an economic downturn ('Downturn LGD estimation').

Other responses

2.16 One respondent asked whether the review of the specification of an economic downturn is expected to happen at least annually. The PRA considers that firms will need to review their identification of an economic downturn at least annually, and update it if a new downturn period is identified. The PRA has decided not to clarify this in the Standards Instrument however, as the PRA considers that the annual review obligation is already set out in Article 185 of the CRR, which requires institutions to validate their internal estimates at least annually.[9]

9 The onshored and amended UK version of Regulation (EU) No 575/2013 of the European Parliament and of the Council of Wednesday 26 June 2013 on prudential requirements for credit institutions and investment firms and amending Regulation (EU) No 648/2012 is referred to as the 'CRR' in this PS.

Appendices

1	**Final Draft UK Technical Standards: Technical Standards (Economic Downturn Instrument) 2021, available at: https://www.bankofengland.co.uk/-/media/boe/files/prudential-regulation/policy-statement/2021/october/ps2321app1.pdf**
2	**Amendments to Supervisory Statement 11/13 'Internal Ratings Based (IRB) approaches', available at: https://www.bankofengland.co.uk/prudential-regulation/publication/2013/internal-ratings-based-approaches-ss**
3	**Guidelines for the estimation of LDG appropriate for an economic downturn ('Downturn LGD estimation'), available at: https://www.bankofengland.co.uk/-/media/boe/files/prudential-regulation/policy-statement/2021/october/downturn-lgd-estimation-gl.pdf**
4	**Guidelines on the application of the definition of default under Article 178 of Regulation (EU) No 575/2013, available at: https://www.bankofengland.co.uk/-/media/boe/files/prudential-regulation/policy-statement/2021/october/application-definition-default-gl.pdf**
5	**Guidelines on PD estimation, LGD estimation and the treatment of defaulted exposures, available at: https://www.bankofengland.co.uk/-/media/boe/files/prudential-regulation/policy-statement/2021/october/application-definition-default-gl.pdf**