IRB models: managing overseas dual compliance

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The PRA recently proposed changes to overseas IRB models used for UK group-consolidated capital requirements. Paul Young looks at what this means and the challenges for dual compliance.

Aimed at UK banks, building societies and Prudential Regulation Authority-designated (PRA) investment firms, Consultation Paper "(CP16/20) Credit Risk: The approach to overseas Internal Ratings Based (IRB) models (October 2020)" aims to clarify the use of non-UK IRB models post-Brexit.

Specifically, the PRA is introducing clearer criteria for using non-European Economic Area (EEA) IRB models, designed for non-EEA regulators, in UK group consolidated capital requirements. The proposed changes will bring non-EEA models in line with PRA expectations and give assurance over their use and supervision.

This builds on Policy Statement "(PS 11/20) Credit risk: Probability of Default and Loss Given Default estimation", published in May. Use of non-UK IRB models is subject to regulatory approval on a case-by-case basis and firms must meet the PRA's specific criteria.

What's changing with IRB models and why?

Firms use IRB models to calculate capital requirements at an individual-entity level, and at a consolidated-group level.

Overseas IRB models are not currently subject to approval by the PRA, instead they fall under the jurisdiction of local (non-EEA) regulators and are designed to meet those expectations. The PRA is concerned about supervision over those models, and the extent to which local regulation is equivalent to the UK's. Small variations are generally made in response to different markets or for specific types of firms.

Two sets of regulatory expectations can leave room for potential arbitrage or the incorrect application of IRB, and may lead to a duplication of effort by creating two simultaneous models for the same exposure. This introduces greater risk and is a threat to safe and sound prudential management. To clarify the situation, the PRA has introduced criteria for use of non-UK IRB models designed for local requirements.

Groups can continue to use overseas IRB models in group-consolidated capital requirements, as long as they are prudently managed and meet the PRA's expectations. Overseas models that do not meet all the PRA's criteria, can't be used for consolidated capital requirements, and groups must build a UK IRB model or request permission to use the standardised approach.

Among other technical requirements, the new criteria includes appropriate internal governance processes over the non-UK IRB models, and appropriate validation of the internal estimates process, which must be objective, consistent and accurate. Groups must also include local regulatory floors and capital add-ons to reflect regional exposures when calculating consolidated capital requirements.

What's the timeline for the new IRB models?

IRB models built to non-UK standards that are not currently used for UK consolidated capital requirements must be compliant by 1 July 2021. While models built to non-UK IRB standards that are currently used for UK consolidated capital requirements can continue to do so, provided they meet the PRA's proposed criteria.

Firms that don't meet the criteria have until 1 January 2023 to remediate non-UK IRB models, in line with the PRA's expectation. This reflects the timeline for the UK's implementation of the final Basel 3.1 rules. So, firms must consider changes to overseas models in the context of the wider capital requirements framework.

There will be significant overlap, so it's important to align changes across the two for consistency and to reduce duplication. For model approval, firms must submit their application and evidence of compliance to the PRA for review.

Despite the end of the Brexit transition period, a deal for financial services is still under discussion, but as it stands, the PRA expects the CRR joint decision framework to come to an end. Current models approved by the joint decision framework can still be used to calculate consolidated capital requirements in the UK. Between now and the proposed implementation dates, the PRA will consider the different regulatory expectations of the relevant EEA regulator, when reviewing applications for model approval.

What to do now?

Dual compliance is the key challenge for UK groups, with overseas subsidiaries using non-UK IRB models. Despite restricting model use to equivalent jurisdictions, there may still be some variation between the PRA's criteria and local regulatory approaches. Achieving and demonstrating dual compliance in a single model will not be easy and, in some cases, firms will still need two separate models.

The proposed changes will demand specialist input, which may further stretch resources during CRD V implementation, the new COVID-19 lockdown and the aftermath of Brexit.

A gap analysis of current overseas models will identify the extent of the work ahead and help with resource allocation, while reviewing current models will include end-to-end processes and any data or technology platforms that need updating. The models may also need updating in the future to reflect a new product or business line, and processes must be in place to support that, including getting re-approval from the PRA.

Similarly, all models will be subject to annual validation by an independent team, and by internal audit, so it's important to embed the PRA's non-UK IRB criteria into these review processes.

Looking beyond dual compliance, the sheer volume of non-UK models is also an issue. Many international groups use a significant number of these models, falling under a multitude of local regulators. Managing and overseeing dual compliance across each jurisdiction, within the PRA's given timeframe, will be a challenge and early action will support successful implementation in the long term.