Financial Services Regulatory Insights

PRA clarifies conditions for use of overseas IRB models

AT A GLANCE

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What's new?

- The PRA published CP16/20 Credit Risk: The approach to overseas Internal Ratings Based (IRB) models on 12 October 2020.
- The CP proposes a set of nine conditions under which firms could continue using models built on non-UK IRB requirements for UK group consolidated reporting purposes. These include a 5% materiality threshold based on overseas models' share of RWAs and exposures, as well as criteria relating to regulatory equivalence and exposure classes.
- These proposed changes are aimed at addressing inconsistencies between UK and non-UK IRB requirements, which can potentially result in imprudent outcomes from use of models built on non-UK IRB requirements.

What does this mean?

- The proposals provide much-needed clarity on the use of non-UK IRB models for UK consolidation purposes.
- Whilst taking a proportionate view with the materiality criteria, the proposals risk changing the status quo for a number of existing IRB banks with non-UK IRB models.
- The proposals imply the PRA will expect EU-headquartered firms with material UK subsidiaries to build UK-specific models. This may create challenges for firms that have already built EU-compliant models.
- The PRA's proposals permit the use of non-UK retail (including SME) IRB models where the other conditions are met. As a result, small portfolios in these classes subject to overseas models are likely to benefit from these proposals.
- However, where firms have larger books, UK compliant IRB models will need to be built. The practical implications of this are unclear for the mortgage segment given a number of UK-specific requirements (e.g. early '90s calibration, HPI shock etc.) are relevant only for UK mortgages.
- The proposed framework does not provide for the use of non-UK wholesale IRB models. The impact of this is expected to be less material given the PRA's approach to wholesale IRB is not materially divergent from the CRR.
- The key exceptions to this relate to EAD modelling, F-IRB floors for low default portfolios and the acceptance of PD/LGD approaches for specialised lending. Therefore, the PRA's proposals may potentially signal the need for firms to build slotting models for a number of segments.
- Consideration should also be given to the ability of firms to use non-UK IRB models for Pillar 2 purposes.

What do firms need to do?

- Firms subject to UK consolidated reporting with material non-UK presence may need to change their modelling plans to consider these proposals – both for wholesale and retail/SME exposures.
- Firms will also need to interpret a number of judgemental areas in the consultation paper and engage with the PRA, as appropriate.

Next steps

Firms should look to assess the portfolios and legal entities affected by these proposals and consider performing an impact analysis on their non-UK IRB portfolios. IRB model change implementation plans may also need to change in light of these proposals; however, a longer implementation timeframe is available.

Contacts

David Wong
Partner

T: +44 (0) 7739 449098
E: david.l.wong@pwc.com

Vivek Kadiyala
Director

T: +44 (0) 7711 589100
E: vivek.kadiyala@pwc.com

Rishi Patel
Director

T: +44 (0) 7738 844788
E: rishi.k.patel@pwc.com

Stefanie Aspden
Manager

T: +44 (0) 7483 407519
E: stefanie.l.aspden@pwc.com

www.pwc.co.uk/regdevelopments

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