Summary of CP16/22 Implementation of Basel 3.1 Standards

Key Takeaways for the Permission to use the IRB Approach and Related Requirements

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Outline

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Disclaimer

Interpretation of proposed changes

This paper outlines the changes proposed to the permission to use the IRB approach, including the changes in the various regulatory notification routes.

Please note that this paper doesn't cover the details of the changes required in the IRB approach, such as exposure classes moving to the Standardised approach (SA) or Foundation Internal Ratings Based (FIRB) approach, nor does it focus on the restrictions on IRB modelling proposed in the CP. These changes will be covered as part of the series being presented on CP16/22, where we focus on individual asset classes (please refer to our recently published paper on Specialised Lending as an example)

Permission to use the IRB approach and related requirements (1 of 4)

	Current Requirements[1]	Proposed Requirements of CP 16/22 (B3.1)
Standards for IRB application approval for new models	▪ Full compliance with requirements in the IRB chapter of the CRR is required for IRB permission	▪ Threshold for approval of IRB permission applications to change from "full compliance" to "material compliance" ▪ Permission to use the IRB approach can be granted when non-compliance is immaterial, that is, impact of the non-compliance on qualitative and quantitative aspects of the firm's IRB approach is minimal ▪ Materiality of non-compliance to be assessed at model level and aggregated level ▪ Materially non-compliant applications will not be approved
	This change has been proposed to: ▪ *Ensure **proportionality** between IRB aspirant firms, who need to ensure full-compliance with all requirements including the ones with immaterial impact before application, and firms with existing IRB permission, who are currently not required to remediate immaterial non-compliance;* ▪ *Ensure a **level playing field**; and* ▪ ***Reduce barriers to entry** to using IRB approaches.* *This change implies greater flexibility for firms to adopt the IRB approach in a timely manner which in turn supports the **relative standing of the UK as a place to operate and encourages competitiveness**.*	
Standards for IRB application approval for material model changes	▪ Approvals are provided to material model changes and extension applications if and only if the application does not introduce any new non-compliance – even if the gaps are immaterial	▪ Specific standards for approval of material model change applications to change from "full compliance" to "material compliance" – in line with proposed approach for new model applications ▪ For applications that are materially non-complaint, approvals may still be granted if: – Application is for changes to existing models only - i.e., applications to adopt more sophisticated modelling approaches for subsets of exposures would not be in scope; – Approval of the application will reduce the overall non-compliance level of the firm's IRB approach; and – A remediation plan is in place to remediate all remaining material non-compliance within a reasonable time period. ▪ PRA to retain the right to take supervisory actions on remaining non-compliance when approval is granted on a material model change that is materially non-compliant
	*This change has been proposed to **facilitate timely remediation of existing non-compliance** by enabling firms to replace non-compliant IRB models that may be a threat to safety and soundness with IRB models that, despite themselves being non-compliant, are more likely to ensure that firms' RWAs better capture risk, thus promoting sustainable growth and relative standing of the UK as a place to operate.* *This change will also help with **efficient and economic use of PRA resources** by reducing the amount of resources needed to assess immaterial issues.*	

1: Current requirements in the UK firms as per CRR and Supervisory Statements and RTS issued by the PRA

Permission to use the IRB approach and related requirements (2 of 4)

	Current Requirements[1]	Proposed Requirements of CP 16/22 (B3.1)
Post model adjustments (PMA)	▪ PMAs are widely used to adjust RWAs produced by models on a temporary basis ▪ No specific guidance available on the calculation and/or the monitoring requirements of PMAs	▪ PMAs are only applied on a temporary basis - firms are required to address all deficiencies in a timely manner ▪ A PMA framework must be developed and applied at a portfolio level (where portfolio is defined as the subset of assets covered by the same models) ▪ The RWA and EL adjustments should be made as a portfolio level add-on on the approved models, irrespective of which model component (PD, LGD, EAD or CCF) the adjustment is for - the underlying models should not be recalibrated or changed in order to give a desired capital requirements outcome ▪ A firm's existing models should remain in place until approval has been received or requirements for ex-ante notifications have been met, these models should continue to be monitored ▪ Model monitoring information to senior management should include information covering: – the portfolio and model component affected; – a description of the issue, why it requires the adjustment and the date when the issue was first identified; – what action is being taken to address the issue and the timeline for this action; and – the increase to RWAs and EL as a result of the adjustment. ▪ Only adjustments that increase RWAs and EL should be made, and there should be no netting of adjustments across portfolios – netting of impacts can only be applied within a portfolio ▪ Netting of adjustments across model components are allowed only if this is done with appropriate conservatism ▪ All parameter and risk weight floors must be applied as per the proposal before PMAs are assessed
	__Clearer guidance__ on PMA calculations and associated monitoring requirements strengthen __relative standing of the UK as a place to operate__ while maintaining relevance to international standards.	
Application of requirements to UK groups applying the IRB approach on a unified basis	▪ No change	▪ Certain conditions and governance structures are to be met where a firm is reliant upon a rating system or data provided by another member of its group or where a firm's rating systems are used on a unified basis, as currently in SS 11/13 (paragraphs 2.1 to 2.3 and 5.1). It is proposed that these paragraphs will move to the draft SS 'Credit Risk: internal ratings based approaches' paragraphs 2.8 to 2.1

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Permission to use the IRB approach and related requirements (3 of 4)

	Current Requirements[1]	Proposed Requirements of CP 16/22 (B3.1)
Overseas Model Approach (OMA)[2]	▪ The scope of OMA models with respect to equivalent jurisdictions is determined by CRR article 142(2)	▪ The OMA model scope related to jurisdictions will be determined by CRR article 114(7) ▪ Existing conditions for allowing permission to use OMA remain unchanged ▪ A specific permission for use of the OMA will be introduced, but firms with existing permission to use OMA models do not need to reapply
	It is proposed that CRR article 142(2) will be revoked by HMT and not replaced in PRA rules.	
Submission of applications and notifications relating to the IRB approach	▪ Regulatory notification route and documentation requirements are determined via commission delegated regulations (EU) 529/2014 ▪ The documentation requirements for notifications ex-ante (pre-notification) and ex-post (post-notification) are not as rigorous as pre-approval application packages	▪ The criteria for notification route and associated documentation requirements will be part of new PRA rules and will be amended to improve the clarity of the framework and align with the proposals in the CP ▪ Self-assessment of relevant CRR articles, PRA rules and supervisory statements will be required for any regulatory notifications and applications ▪ Documentation requirements for notifications will be aligned with those for pre-approval applications, to better reflect existing practice
	*Better **clarity and consistency** across different application package requirements.*	
Senior management responsibility	▪ No change ▪ The PRA considers that the disclosure proposals would continue the existing PRA requirement for the management body or senior management to maintain internal processes, systems, and controls to verify that the firm's disclosures are appropriate and in compliant with PRA rules, including the existing attestation requirements. The proposals set out will increase the volume of disclosures subject to senior management oversight and attestation	

1: Current requirements in the UK firms as per CRR and Supervisory Statements and RTS issued by the PRA

2: Refer to Appendix 3 for a definition of OMA

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Permission to use the IRB approach and related requirements (4 of 4)

	Current Requirements[1]	Proposed Requirements of CP 16/22 (B3.1)
Use test and experience test	▪ No change ▪ Guidance on the use and experience tests will be in paragraph 4.1 to 4.7 of the draft SS 'Credit Risk: internal ratings based approaches', having previously been covered in paragraphs 208 to 210 of EBA/GL/2017/16 and paragraphs 10.6A to 10.6D of SS11/13	
Assessment of non-compliance and remediation plans	▪ The materiality of non-compliance is subjective based on the firm's internal assessment and guidance	▪ Materiality of non-compliance needs to be assessed according to CRR articles 143(1)(a), 143(2)(b), 143(3)(b), 146(1)(b) and 149(2)(a) ▪ Non-compliance will be deemed as immaterial if the impact on qualitative and quantitative aspects of the firm's IRB approach is minimal ▪ For materially non-compliant items (non-compliance with CRR, PRA Supervisory statements on IRB and any other relevant regulatory requirements) firms are required to submit a remediation plan for timely return to compliance ▪ These remediation plans must be realised within a time period agreed with the PRA
	__Clearer guidance__ on assessment and criteria for deciding materiality of non-compliance __strengthen relative standing of the UK as a place to operate__ while maintaining relevance to international standards. This will also __promote sustainable growth__.	
Annual attestations	▪ An annual Senior Management Function (SMF) attestation and attestation of compliance for material model change required ▪ Not all regulatory notifications need to be accompanied by self-assessment against relevant regulatory articles	▪ The scope of the annual SMF attestation will be extended to: – Cover compliance with PRA rules; and – Include the proposed implementation of an appropriate and credible remediation plan, where the firm is materially non-compliant. ▪ All firms will need to submit a list of their IRB models included within the scope of their IRB permission annually
	__Better visibility__ into existing non-compliance and facilitate timely remediation of existing non-compliance which in turn will __support sustainable growth__.	

1: Current requirements in the UK firms as per CRR and Supervisory Statements and RTS issued by the PRA

Implementation timelines

IRB permissions

- All existing IRB permissions issued under CRR will hold, to avoid firms needing to re-apply for existing permissions
- For changes necessary to ensure compliance with the proposals set out in the consultation paper (CP), the PRA will, where necessary, vary these permissions from the **1st of January 2025** using its powers under section 144G of FSMA 2000

IRB roadmap

- IRB roadmap submission deadline has been delayed for models that are most likely to be affected by the proposals set out in the CP to help ensure a co-ordinated and proportionate approach. Firms will be given a sufficient period after the publication of the "near-final" policy statement to submit delayed IRB roadmap model changes
- All other non-delayed IRB roadmap model change applications to be submitted to the PRA by **H2 2022** and implemented in advance of the proposals set out in the CP

Non-modelling changes

- Non-modelling related changes and input floors, covering the following, to be implemented by the **1st of January 2025**:
  - All restrictions on scope of IRB models (such as EAD modelling restrictions, Standardised or F-IRB approach)
  - All changes to LGD and EAD under FIRB approach
  - All changes to maturity calculation
  - All IRB input floors
- This would not require a specific regulatory notification

Modelling changes

- Any model change requests to ensure compliance with the proposals in the CP to be submitted after the **1st of July 2024**
- Where IRB models are not fully compliant with the proposals, firms need to have:
  - An appropriate remediation plan and implementation date agreed with the PRA or demonstrate that the impact of the non-compliance is immaterial; and
  - An appropriate PMA or PMA assessment in place to cover any shortfall in RWA.

Who are we

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Themes considered

Themes considered by the PRA when proposing CP 16/22

The consideration of the Consultation Paper (CP) is to align with Basel III standards and promote safety and soundness of the firms it regulates. It has been highlighted that PRA considered the below aspects, if not more, for this CP, which are referred as "have regards" factors by the PRA

Relative standing of the UK as a place to operate and competitiveness	to support the ***competitiveness*** and the ***relative standing*** of the UK while ensuring the ***safety and soundness*** of firms and ***strengthening UK financial stability***
Relevance to international standards	to ensure adherence to ***international standards***, which in turn supports the ***relative standing of the UK*** and positions the UK as one of the largest global financial centres
Proportionality	even if some of the proposals are expected to create cost for the firms in the short term, these costs will not persist over time and the firms are expected to benefit from a clearer clarification of requirements which would justify any increase in costs. Some of the proposed changes will also bring ***proportionality between IRB aspirant firms and IRB incumbent firms***, thus ensuring a ***level playing field*** and ***reducing barriers to entry*** to using IRB approaches
Sustainable growth	to ensure that firms are ***appropriately capitalised*** for the risks that they face, such that they can continue providing finance for the real economy throughout the economic cycle
Efficient and economic use of PRA resources	having more ***visibility and clearer guidance*** on systems and processes as well as limiting modelling choices will ensure an efficient use of PRA's resources in areas that need ongoing monitoring and engagements, such as monitoring firms' initial implementations and ongoing applications
Climate Change and 2050 net-zero target	although specific climate risk related measures are not in scope of the CP or Basel 3.1 standards, some of the proposals are ***motivated by net-zero target***, such as changes proposed in Specialised Lending exposures can enable firms to model certain Specialised Lending exposures (A-IRB and F-IRB) and in turn encourage them to invest in green finance projects
Different business models	while the proposed changes ensure ***capital adequacy and risk-sensitivity***, the impact of the changes can have varying influences on firms based on their ***business mix*** and ***risk profile*** and therefore aligning with one of the objectives of Basel 3.1 standards

Definitions

Appendix: Definitions

Overseas Model Approach (OMA)

Per PRA Rulebook (CRR) Instrument [2023][1]:

Overseas Model Approach means an approach that allows the use of non-UK rating systems developed to meet non-UK IRB requirements, in the calculation of UK consolidated capital requirements in accordance with a permission granted under Article 143(6) of draft instrument

Post model adjustments (PMAs)

Per PRA Rulebook (CRR) Instrument [2023]:

Post model adjustments refer to the adjustments relating to material non-compliance referred to in Article 146(3) of draft instrument

1: Currently a draft instrument to accompany CP 16/22 'Implementation of the Basel 3.1 standards'

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