BANK OF ENGLAND
PRUDENTIAL REGULATION
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Consultation Paper | 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

April 2021

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April 2021

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Responses are requested by Wednesday 7 July 2021.

In light of current measures to help prevent the spread of COVID-19, please address any comments or enquiries by email to: CP7_21@bankofengland.co.uk.

Alternatively, please address any comments or enquiries to:
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Contents

1 Overview

1.1 This Consultation Paper (CP) sets out the Prudential Regulation Authority's (PRA) proposed approach to implementing new requirements relating to the specification of the nature, severity, and duration of an economic downturn in the internal ratings based (IRB) approach to credit risk.

1.2 The proposals in this CP would result in new UK Technical Standards (Appendix 1) and amended expectations in Supervisory Statement (SS) 11/13 'Internal Ratings Based (IRB) approaches' [1] (Appendix 2).

1.3 The PRA is also proposing to make additional minor changes to SS11/13 to reflect the UK's exit from the EU, which are summarised in Chapter 3 of this CP and set out in Appendix 2.

1.4 The proposals are relevant to UK banks, building societies, and PRA-designated UK investment firms.

Background

1.5 In 2016, the European Banking Authority (EBA) published a set of regulatory products (the IRB roadmap) with the aim of reducing unwarranted variability in risk-weighted assets (RWAs) calculated using banks' IRB models.[2]

1.6 The PRA considers that it is important to reduce unwarranted variability from IRB models, and has previously set out its implementation of parts of the IRB roadmap, for example in Policy Statement (PS) 7/19 'Credit risk: the definition of default'[3] and in PS11/20 'Credit risk: Probability of Default and Loss Given Default estimation'.[4]

1.7 One of the products from the EBA's IRB roadmap relates to the specification of an economic downturn: the final draft Regulatory Technical Standards (RTS) on the specification of the nature, severity and duration of an economic downturn in accordance with Articles 181(3)(a) and 182(4)(a) of Regulation (EU) No 575/2013 ('the RTS on economic downturn').[5] The EBA published its final draft RTS on Friday 16 November 2018, and then its opinion on the European Commission's amendments relating to the final draft RTS on Monday 31 August 2020.[6]

1.8 The PRA noted in PS11/20 that the RTS was in draft at the time of the PS's publication. PS11/20, which included relevant changes to SS11/13, assumed that the RTS would be made before the end of the transition period in the same form as the draft. At that time the PS stated that further changes to SS11/13 would be considered if the final RTS differed from the draft, and that the requirements of the RTS would only apply once the final RTS had entered into force and applied in the UK. The final RTS was not finalised in the EU before the end of the transition period, and therefore it did not get automatically converted into UK law as 'retained EU law' under the European Union (Withdrawal) Act 2018.[7]

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1 December 2013: https://www.bankofengland.co.uk/prudential-regulation/publication/2013/internal-ratings-based-approaches-ss.
2 https://www.eba.europa.eu/eba-sets-out-roadmap-for-the-implementation-of-the-regulatory-review-of-internal-models.
3 March 2019: https://www.bankofengland.co.uk/prudential-regulation/publication/2018/credit-risk-the-definition-of-default.
4 May 2020: https://www.bankofengland.co.uk/prudential-regulation/publication/2019/credit-risk-probability-of-default-and-loss-given-default-estimation.
5 https://www.eba.europa.eu/sites/default/documents/files/documents/10180/2459703/3136b895-0dfb-454f-8984-beddb888b8cc/EBA%20BS%202018%20xxx%20%28Final%20draft%20RTS%20on%20economic%20downturn%29_final%20%28002%29.pdf?retry=1.
6 https://www.eba.europa.eu/sites/default/documents/files/document_library/Publications/Opinions/2020/930458/EBA-Op-2020-12%20Opinion%20on%20RTS%20on%20Downturn.pdf.
7 Available at: https://www.legislation.gov.uk/ukpga/2018/16/contents/enacted.

1.9 The PRA considers that it is appropriate to introduce requirements for identifying an economic downturn in order to foster greater comparability of capital requirements across firms. Therefore, this CP sets out the PRA's proposed approach to implementing appropriate requirements as UK technical standards, and to update its expectations in SS11/13 accordingly.

1.10 In order to improve efficiency for firms, the PRA has used the version of the RTS in the EBA's 2020 opinion paper as a start point for developing its proposed technical standards, and has provided additional clarity in some areas to further advance its statutory objectives. As firms will already be familiar with the requirements set out in the final draft RTS, and as the PRA was directly involved in the EBA development and negotiation of this draft RTS prior to the UK's exit from the EU, the PRA considers that this approach facilitates effective and efficient implementation of these requirements.

1.11 The PRA is also proposing some minor changes to SS11/13, mainly to update the text to reflect the UK's withdrawal from the EU and the end of the transition period.

Implementation

1.12 The PRA proposes that the implementation date for the changes resulting from this CP would be Saturday 1 January 2022, in line with the implementation deadlines set out in PS11/20 for IRB firms to implement all changes from the IRB roadmap (except in respect of the RTS on materiality thresholds for firms only using the standardised approach, where the implementation deadline was Thursday 31 December 2020). Firms should continue to submit model change applications in line with the submission timings communicated by their supervisors.

Responses and next steps

1.13 This consultation closes on Wednesday 7 July 2021. The PRA invites feedback on the proposals set out in this consultation. The PRA also invites feedback from firms on the expected impact of the proposals on capital requirements. Please address any comments or enquiries to CP7_21@bankofengland.co.uk.

1.14 The proposals set out in this CP have been designed in the context of the UK having left the EU and the transition period having come to an end. Unless otherwise stated, any references to EU or EU derived legislation refer to the version of that legislation which forms part of retained EU law.[8] The PRA will keep the policy under review to assess whether any changes would be required due to changes in the UK regulatory framework.

8 For further information please see https://www.bankofengland.co.uk/eu-withdrawal/transitioning-to-post-exit-rules-and-standards.

2 Proposals

2.1 This chapter sets out the PRA's proposed requirements for specifying the nature, severity, and duration of an economic downturn, for the purposes of calibrating both downturn loss given default (LGD) and exposure at default (EAD).

2.2 The PRA's rationale for proposing requirements that specify the nature of an economic downturn is to ensure that consistent and relevant economic indicators are considered. The PRA's rationale for proposing to introduce requirements that specify the severity and duration of an economic downturn is to ensure that downturn estimates of LGD and EAD reflect consistent and sufficiently severe downturn scenarios, and that the selected downturn period is of sufficient duration to adequately capture the economic impact of a particular downturn event.

2.3 The PRA proposes to make technical standards setting out requirements relating to identifying economic downturns, as set out in Appendix 1, and to update the relevant section of its expectations in SS11/13, as set out in Appendix 2.

The nature of economic downturns

2.4 Within the proposed technical standards, the PRA is proposing a consistent set of economic indicators that would be considered relevant for all exposures, as the PRA considers them to be key indicators of an economic cycle:

(a) gross domestic product (GDP);

(b) unemployment rate;

(c) externally provided aggregate default rates, where available; and

(d) externally provided aggregate credit losses, where available.

2.5 In addition to the indicators relevant to all exposures listed above, the PRA considers these additional indicators of an economic cycle (for the relevant material jurisdictions, geographical areas, or sectors) to be relevant for particular portfolios:

(a) for exposures to corporates: relevant sector-specific indices or relevant industry-specific indices;

(b) for retail exposures to small and medium-sized enterprises (SMEs): relevant sector-specific indices or relevant industry-specific indices;

(c) for exposures to corporates secured by residential property collateral and for retail exposures secured by residential property collateral: house prices or house price indices;

(d) for exposures to corporates secured on commercial immovable property collateral and for retail exposures to SMEs secured on commercial immovable property collateral: commercial immovable property prices or commercial immovable property price indices, and commercial immovable property rental prices or commercial immovable property rental price indices;

(e) for retail exposures other than those falling within point (b), (c) or (d): total household debt and disposable personal income, in each case where available;

(f) for income-producing real estate: immovable property prices or immovable property price indices, immovable property rental prices or immovable property rental price indices, for residential, commercial or industrial property as applicable;

(g) for project finance: prices for the underlying products supplied;

(h) for object finance: indices for the relevant type or types of collateral;

(i) for commodity finance: prices or price indices for the relevant type of commodity; and

(j) for exposures to institutions: financial credit indices.

2.6 As well as the additional factors listed above, the PRA proposes that other variables should be considered relevant where they are explanatory variables or indicators of the economic downturn under consideration.

2.7 The PRA also proposes to introduce a general proportionality provision that firms need only consider the listed economic indicators to identify a downturn where they would not incur disproportionate costs.

The severity of an economic downturn

2.8 For the purpose of specifying the severity of the economic downturn, and for identifying the most severe values associated with each relevant economic indicator, the PRA proposes to require firms to use a historic time period that is sufficiently long to provide values that are representative of the values that may be taken by those economic indicators in the future, including in a future severe downturn.

2.9 Additionally, the PRA proposes to require firms to consider a period of at least 20 years in order to promote consistency of firms' downturn estimates. The PRA did consider whether a period of less than 20 years should be permitted in certain circumstances, but did not consider this to be prudentially appropriate, as it could lead to an undue risk that the sufficiently severe downturn would not be appropriately identified.

2.10 Where this period of data does not contain sufficiently severe values for a considered economic factor, the PRA proposes an additional expectation that the selected period should result in estimates that are sufficiently severe.

The duration of an economic downturn

2.11 For the purposes of specifying the duration of an economic downturn, the PRA proposes that a single downturn period should be long enough to cover all the peaks or troughs related to the most severe 12-month values observed for the different economic indicators associated with that single downturn period.

2.12 In cases where the single downturn period is not long enough to cover the most severe 12-month values observed for the different economic indicators associated with that single downturn period, the PRA proposes that longer durations of downturn periods should be considered. As such, the PRA proposes that the downturn period be extended to be long enough to reflect the prolonged severity of the indicators in question.

2.13 In order to capture cases where indicators' 12-month values peak or trough at the same time or shortly after one another, the PRA proposes to introduce a requirement that firms shall combine economic downturns into a single downturn period.

2.14 The PRA considered whether economic indicators should be 'significantly correlated' in order for separate peaks or troughs reached simultaneously, or shortly thereafter, to be combined in a single downturn period. However, indicators that reach their most severe value simultaneously or shortly after each other are very likely to be correlated; therefore, the PRA considers that including a 'significant correlation' requirement does not add additional value to the proposed technical standards.

3 Additional minor changes to SS11/13

3.1 The PRA is also proposing to make additional minor changes to SS11/13 to reflect the UK's withdrawal from the EU, as set out in Appendix 2. These changes would bring the SS in line with the version of the Capital Requirements Regulation (CRR) that was onshored at the end of the transition period on Thursday 31 December 2020. These changes replicate the effect of the general guidance set out in SS1/19 'Non-binding PRA materials: The PRA's approach after the UK's withdrawal from the EU'.[9]

3.2 The PRA is proposing the following changes to SS11/13:

(a) to remove the following references to EBA processes that no longer apply in the UK:

- references in paragraphs 1.6 and 12.36 to ongoing and planned EBA Binding Technical Standards;
- the reference in paragraph 1.4 to the joint decision process between the PRA and other European Economic Area (EEA) regulators; and
- the reference in footnote 6 (to paragraph 11.6A) to passporting;

(b) to update legislative references to Capital Requirements Directive and CRR in footnote 1 (to paragraph 1.1) and paragraph 6.7 with the corresponding UK references;

(c) to make consequential changes to references in paragraphs 2.1, 5.1, 6.6, and 6.7 by replacing references to EEA parents or to EEA consolidation groups with references to UK parents or UK consolidation groups; and

(d) to add an overarching reference to clarify that where this SS 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. The PRA does not expect firms to comply with changes to those Guidelines that are made by the EBA after the end of the transition period on Thursday 31 December 2020.

3.3 Alongside the changes to SS11/13 to reflect the UK's withdrawal from the EU, the PRA is also proposing to update the reference to the individual required to make the attestation required in SS11/13 paragraph 5.2, to reflect that it should be an individual in a Senior Management Function (SMF) role rather than a Significant Influence Function (SIF) role.

3.4 The PRA proposes to update SS11/13 with effect from Saturday 1 January 2022 in line with the implementation date for the other proposals in this CP. Firms should; however, interpret changes related to the UK's withdrawal from the EU in light of any use of the transitional relief[10] provided by the PRA under the temporary transitional power until its expiry on Thursday 31 March 2022.

9 December 2020: https://www.bankofengland.co.uk/prudential-regulation/publication/2019/non-binding-pra-materials-the-pras-approach-after-the-uks-withdrawal-from-the-eu-ss.

10 Available at: https://www.bankofengland.co.uk/eu-withdrawal/temporary-transitional-power.

4 The PRA's statutory obligations

4.1 In carrying out its policy making functions, the PRA is required to comply with several legal obligations. Before submitting a standards instrument to HM Treasury for approval, the Financial Services and Markets Act 2000 (FSMA)[11] requires the PRA to publish a draft of the proposed technical standards accompanied by:

- a cost benefit analysis;
- an explanation of the PRA's reasons for believing that making the proposed technical standards is compatible with the PRA's duty to act in a way that advances its general objective,[12] insurance objective[13] (if applicable), and secondary competition objective;[14]
- an explanation of the PRA's reasons for believing that making the proposed technical standards are compatible with its duty to have regard to the regulatory principles;[15] and
- a statement as to whether the impact of the proposed technical standards will be significantly different to mutuals than to other persons.[16]

4.2 The Prudential Regulation Committee (PRC) should have regard to aspects of the Government's economic policy as recommended by HM Treasury.[17]

4.3 The PRA is also required by the Equality Act 2010 to have due regard to the need to eliminate discrimination and to promote equality of opportunity in carrying out its policies, services and functions.[18]

Cost benefit analysis

4.4 This CP proposes to introduce UK technical standards and update the PRA's expectations for elements of the IRB framework that relate to the identification of an economic downturn and the resultant estimation of downturn LGD and EAD. Overall, the PRA considers that the expected costs of this proposal are outweighed by its benefits.

4.5 The PRA is not required to perform a full cost benefit analysis of the changes proposed in Chapter 3. These are mostly consequential changes reflecting the UK's withdrawal from the EU. The changes reflect what is already 'read into' the text by the action of SS1/19 'Non-binding PRA materials: The PRA's approach after the UK's withdrawal from the EU'.[19] Updating the text directly will increase transparency and will not impose any additional costs on firms. The other minor change proposed in Chapter 3, which does not reflect the UK's withdrawal from the EU, but rather replaces an out-of-date reference to a SIF role, and will improve clarity without imposing any additional costs on firms.

4.6 There are two main benefits of the proposals in this CP. Firstly, they aim to ensure that identified downturns are sufficiently severe in order to reduce the risk of underestimation of firms'

11 Section 138J of FSMA.
12 Section 2B of FSMA.
13 Section 2C of FSMA.
14 Section 2H(1) of FSMA.
15 Sections 2H(2) and 3B of FSMA.
16 Section 138K of FSMA.
17 Section 30B of the Bank of England Act 1998.
18 Section 149.
19 April 2019: https://www.bankofengland.co.uk/prudential-regulation/publication/2019/non-binding-pra-materials-the-pras-approach-after-the-uks-withdrawal-from-the-eu-ss.

capital requirements. Secondly, implementing these requirements should give firms clarity on the PRA's expectations of the application of the CRR requirements to identify an economic downturn, as well as the consequent estimation of downturn LGD and EAD. This should ensure that firms identify a sufficiently severe downturn in their estimates of downturn LGD and EAD.

4.7 The proposals should reduce variability within the IRB framework and increase the comparability of IRB risk parameters, risk weighted assets, and capital metrics among UK firms. This should help ensure that differences in estimates across firms are based on risk and not on different practices or interpretations. This should also help ensure that information provided to the market on IRB risk weights is comparable across firms, therefore supporting market confidence and market discipline.

4.8 Due to firms already being required to identify an economic downturn under the CRR, the PRA considers that firms are unlikely to incur any additional material costs as a result of these proposals, even if processes in place currently differ in some respects.

4.9 As set out in paragraph 1.8 above, the PRA noted in PS11/20 that the RTS was in draft at the time of the PS's publication. The PRA's proposed technical standards do not substantially differ to the draft RTS. Where firms have already begun preparations to comply based on the draft RTS text, the PRA considers that it is not likely that firms will need to fully rebuild or make substantive changes to their models, or planned changes to models, as a result of these proposals.

4.10 In addition, the draft RTS on economic downturn is closely related to the Guidelines (GL) on downturn LGD. In PS11/20 and SS11/13, the PRA set an expectation that firms should comply with the GL on downturn LGD. The PRA considers it would not be suitable to expect compliance with the GL without implementation of the substantive requirements of the draft RTS on economic downturn, as they are directly linked to one another.

4.11 Some firms may need to recalibrate their models based on data from a downturn as a result of the proposals in this CP, and that may lead to an increase in capital requirements. However, the PRA considers that this would only result in a material cost where there are deficiencies in a firm's current approach to identifying an economic downturn. The PRA considers that any incremental cost incurred by the proposals in this CP would be outweighed by the benefit in supporting the PRA's objectives of safety and soundness.

Compatibility with the PRA's objectives

4.12 The proposals in this CP would contribute to promoting the safety and soundness of firms by ensuring appropriate identification of an economic downturn to be used when calibrating LGD and EAD in a downturn, and would therefore facilitate the prudent calculation of capital requirements. The proposals would also help to ensure that any differences in IRB risk parameters or capital requirements are based on risk and not on different practices or interpretations.

4.13 The PRA has assessed whether the proposals set out in this CP facilitate effective competition. The proposals in this CP should advance competition on two fronts, as they apply equally to both existing and prospective IRB applicants to facilitate a level playing field, and should also increase the consistency of modelling approaches and capital requirements across firms that use the IRB approach.

Regulatory principles

4.14 In developing the proposals in this CP, the PRA has had regard to the regulatory principles. Three of the principles are of particular relevance:

(i) the principle that a burden or restriction which is imposed on a person should be proportionate to the benefits which are expected to result from the imposition of that burden;

(ii) the desirability of sustainable growth in the economy of the UK in the medium or long term; and

(iii) the desirability of the PRA exercising its functions in a way that recognises differences in the nature of businesses carried on by different persons.

4.15 With regard to principle (i), the PRA has proposed a proportionality principle in the proposed technical standards relating to the identification of economic indicators which would dis-apply the requirement to include certain indicators where doing so would result in disproportionate costs being incurred (for example, due to the cost of obtaining a particular type of external data). The PRA considers that the proposals achieve an appropriate balance between the burden of the proposals and the prudential benefits, as set out in the cost benefit analysis.

4.16 With regard to principle (ii), reducing unwarranted variability in firms' capital requirements and model estimations should help to promote confidence among investors and other market participants that firms' capital requirements are sufficient, as well as ensuring that disclosures provided about firms' capital requirements for credit risk are comparable across firms, enabling the market to impose its own discipline on firms that use the IRB approach.

4.17 With regard to principle (iii), the PRA has taken the fact that firms have different business models into consideration, and considers that the proposals would not undermine the extent to which firms' IRB models remain reflective of their business models and risk profiles.

Impact on mutuals

4.18 The PRA considers that the impact of the proposed technical standards on mutuals is expected to be no different from the impact on other firms.

HM Treasury recommendation letter

4.19 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.[20]

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

(i) competition;

(ii) growth; and

(iii) competitiveness

4.21 Aspects (i) and (ii) have been considered in the 'Compatibility with the PRA's objectives' and 'Regulatory principles' sections above. Consideration of aspect (iii) on competitiveness is set out below.

20 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.

4.22 The principal aim of this CP is to reduce unwarranted variability within the IRB framework. Given that the PRA has used the draft RTS in the EBA's opinion paper as a basis for developing its proposed requirements, implementing these requirements in the UK should (provided the RTS is implemented in a similar form in the EEA) increase consistency of modelling approaches and capital requirements between UK firms and EEA firms. Therefore, the PRA does not consider that the proposals will inhibit or disadvantage the competitiveness of the UK banking industry relative to other jurisdictions.

Equality and diversity

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

Appendices

1 Draft UK Technical Standards: Technical Standards (Economic Downturn Instrument) 2021:

PRA STANDARDS INSTRUMENT: TECHNICAL STANDARDS (ECONOMIC DOWNTURN) INSTRUMENT [2021]

Powers exercised

A. The Prudential Regulation Authority ("PRA") makes this instrument in the exercise of powers under section 138P (Technical Standards) in the Financial Services and Markets Act 2000 ("the Act").

B. For the purposes of section 138P of the Act, the powers to make technical standards which the PRA relies on are conferred on the PRA by Articles 181(3) and 182(4) of Regulation (EU) 575/2013.

C. The powers referred to above are specified for the purpose of section 138Q(2) (Standards instruments) of the Act.

Pre-conditions to making

D. The FCA has been consulted on this instrument pursuant to section 138P(4) of the Act.

E. In accordance with section 138J of the Act, the PRA published a draft of the proposed instrument and had regard to representations made.

F. A draft of this instrument has been approved by the Treasury, as required by section 138R of the Act.

Commencement

G. This instrument comes into force on [1 January 2022]

Citation

H. This instrument may be cited as the PRA Standards Instrument: Technical Standards (Economic Downturn) [2021].

By order of the Prudential Regulation Committee
[DATE]

1 DEFINITIONS

1.1 In this Instrument, the following definitions shall apply:

(1) *CRR*

means Regulation (EU) No 575/2013 of the European Parliament and of the Council of 26 June 2013 on prudential requirements for credit institutions and investment as it forms part of retained EU law

(2) *exposures to corporates*

means exposures to corporates as referred to in Article 147(2)(c) of the *CRR*

(3) *exposures to institutions*

means exposures to institutions as referred to in Article 147(2)(b) of the *CRR*

(4) *residential property*

has the meaning set out in Article 4(1)(75) of the *CRR*

(5) *retail exposures*

means retail exposures as referred to in Article 147(2)(d) of the *CRR*

(6) *specialised lending exposures*

means specialised lending exposures as referred to in Article 147(8) of the *CRR*

(7) *type of exposures*

has the meaning set out in Article 142(1)(2) of the *CRR*

1.2 Unless otherwise defined, any italicised expression used in this Instrument and in the *CRR* has the same meaning as in the *CRR*.

2 SPECIFICATION OF NATURE, SEVERITY AND DURATION OF AN ECONOMIC DOWNTURN

2.1 For the purposes of Article 181(1)(b) and 182(1)(b) of the *CRR*, an economic downturn shall be identified for each *type of exposures*.

2.2 In identifying an economic downturn for a given *type of exposures*, the following specification rules shall apply:

(1) the nature of an economic downturn is characterised by a set of economic indicators that are classified as relevant for exposures within that *type of exposures* in accordance with 3.1 and 3.2 ('the relevant indicator set');

(2) in terms of severity, an economic downturn is indicated by the most severe value relating to a 12-month period ('the most severe 12-month value') that is observed, for each economic indicator in the relevant indicator set, over a historical time-span determined for that economic indicator in accordance with 4.1 ('the applicable time-span');

(3) an economic downturn is comprised of one or more distinct downturn periods covering the peaks and troughs related to the most-severe 12-month values for the economic indicators in the relevant indicator set, each such period being of a duration determined in accordance with 5.1 ('the duration of a downturn period').

2.3 For the purposes of 2.2(2), the 12-month periods to which values for an economic indicator relate may start at any point in time within the applicable time-span.

2.4 For the purposes of 2.2(3):

(1) a downturn period is a period in which an economic indicator reaches its most severe 12-month value;

(2) where, for different economic indicators, the peaks or troughs related to the most severe 12-month values are reached simultaneously or shortly after each other, the downturn periods in which those indicators reach their most severe 12-month value are to be treated as one single downturn period covering the most severe 12-month values for all those indicators.

3 RELEVANT INDICATOR SET

3.1 The following economic indicators shall be classified as relevant for exposures within a given *type of exposures* where this would not incur disproportionate costs:

(1) for all *types of exposures*:

(a) gross domestic product;

(b) unemployment rate;

(c) externally provided aggregate default rates, where available;

(d) externally provided aggregate credit losses, where available;

(2) in addition to the economic indicators listed in 3.1(1):

(a) for *exposures to corporates*: relevant sector-specific indices or relevant industry-specific indices;

(b) for *retail exposures* to small and medium-sized enterprises: relevant sector-specific indices or relevant industry-specific indices;

(c) for *exposures to corporates* secured by *residential property* collateral and for *retail exposures* secured by *residential property* collateral: house prices or house price indices;

(d) for *exposures to corporates* secured by commercial immovable property collateral and for *retail exposures* to small and medium-sized enterprises secured by commercial immovable property collateral: commercial immovable property prices or commercial immovable property price indices, and commercial immovable property rental prices or commercial immovable property rental price indices;

(e) for *retail exposures* other than those falling within point (b), (c) or (d): total household debt and disposable personal income, in each case where available;

(f) for *specialised lending exposures*:

(i) in the case of income-producing real estate: immovable property prices or immovable property price indices, immovable property rental prices or immovable property rental price indices, for residential, commercial or industrial property as applicable;

(ii) in the case of project finance: prices for the underlying products supplied;

(iii) in the case of object finance: indices for the relevant type or types of collateral;

(iv) in the case of commodity finance: prices or price indices for the relevant type of commodity;

(g) for *exposures to institutions*: financial credit indices;

(3) in addition to the economic indicators listed in points 3.1(1) and (2), any other economic indicators that are explanatory variables for, or indicators of, the economic cycle specific to exposures in the *type of exposures* under consideration.

3.2 The economic indicators identified for exposures within a *type of exposures* in accordance with 3.1 shall reflect the geographical distribution and, where applicable, the sectoral distribution of the exposures within that *type of exposures*. For this purpose, an economic indicator shall be included in the relevant indicator set:

(1) once for each jurisdiction or, where appropriate, once for each geographical area within a jurisdiction, covered by a material share of that *type of exposures*; and

(2) once for each sector, where applicable, covered by a material share of that *type of exposures*.

3.3 Where economic indicators to be included in accordance with 3.1(2) show strong co-movement across the different jurisdictions or, as applicable, different sectors, a common economic indicator may instead be selected to reflect those jurisdictions or sectors overall.

4 DETERMINING THE APPLICABLE TIME-SPAN

4.1 For the purposes of 2.2(2), the historical time-span applicable to an economic indicator shall be sufficient to provide values that are representative of the likely range of variability of that indicator in the future, and shall in any event have a duration of at least twenty years.

5 DURATION OF A DOWNTURN PERIOD

5.1 For the purposes of 2.2(3), the duration of a downturn period shall be determined as follows:

(1) in a case falling within 2.4(2), the single downturn period shall be a period that is long enough to cover all the peaks or troughs related to the most severe 12-month values observed for the different economic indicators associated with that single downturn period;

(2) in all cases, whether or not falling within 2.4(2), where the various 12-month values observed for the economic indicator or indicators in question over the applicable timespan do not significantly deviate from their most severe 12-month value over a specific, continuous period of time within the applicable time-span, the downturn period shall be long enough to reflect the prolonged severity observed for the economic indicator or indicators in question;

(3) in all cases, whether or not falling within 2.4(2), where:

(i) the economic indicator or indicators show adjacent peaks or troughs to the peaks or troughs related to the most severe 12-month values observed for the economic indicator or indicators in question over the applicable time-span,

(ii) the adjacent peaks and troughs do not significantly deviate from the most severe 12-month value observed for that indicator or those indicators over that time-span, and

(iii) the adjacent peaks and troughs are related to the same overall economic condition,

the downturn period shall be long enough to reflect the whole prolonged period over which the adjacent peaks or troughs are observed;

(4) where neither (1), (2) or (3) apply, the downturn period shall be the 12-month period to which the most severe 12-month values of the economic indicator or indicators relate.

2 Draft amendments to Supervisory Statement 11/13 – 'Internal Ratings Based (IRB) Approaches'

In this appendix, new text is underlined and deleted text is struck through. It is proposed these changes will take effect from Saturday 1 January 2022.

…

1 Introduction

1.1 This Supervisory Statement (SS) is aimed at firms to which ~~CRD IV1~~the Capital Requirements Regulation[1] applies.

…

~~1.4 Firms should be aware that where approval to use the IRB approach is subject to a joint decision under CRR Article 20, the expectations set out in this supervisory statement will be subject to discussion between the PRA and other EEA regulators regarding the joint decision.~~

…

~~1.6 Some parts of this supervisory statement will require revision in due course as a result of the development by the EBA of binding technical standards required by the CRR. The PRA expects to amend or delete these parts of this supervisory statement when those technical standards enter into force.~~

1~~Capital Requirements Directive (2013/36/EU)(CRD) and~~ Capital Requirements Regulation ~~(575/2013)~~(575/2013) UK Law (CRR) ~~– jointly 'CRD IV'~~.

1.8 Where this SS 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. The PRA does not expect firms to comply with changes to those Guidelines that the EBA makes after the end of the transition period (11pm on Thursday 31 December 2020).

…

2 Application of requirements to ~~EEA~~UK groups applying the IRB approach on a unified basis

2.1 The CRR provides that where the IRB approach is used on a unified basis by an ~~EEA~~UK group, the PRA is required to permit certain IRB requirements to be met on a collective basis by members of that group. The PRA considers that where a firm is reliant upon a rating system or data provided by another member of its group it will not meet the condition that it is using the IRB approach on a unified basis unless:

(a) the firm only does so to the extent that it is appropriate, given the nature and scale of the firm's business and portfolios and the firm's position within the group;

(b) the integrity of the firm's systems and controls is not adversely affected;

(c) the outsourcing of these functions meets the requirements of SYSC; and

(d) the abilities of the PRA and the lead regulator of the group to carry out their responsibilities under the CRR are not adversely affected.

…

5 Corporate governance

5.1 Where a firm's rating systems are used on a unified basis pursuant to CRR Article 20(6), the PRA considers that the governance requirements in CRR Article 189 can be met only if the subsidiary undertakings have delegated to the governing body or designated committee of the ~~EEA~~UK parent institution, ~~EEA~~UK parent financial holding company or ~~EEA~~UK parent mixed financial holding company responsibility for approval of all material aspects of rating and estimation processes.

5.2 The PRA expects an appropriate individual in a ~~Significant Influence Function (SIF)~~Senior Management Function (SMF) role to provide to the PRA on an annual basis written attestation that:

(i) the firm's internal approaches for which it has received a permission comply with the CRR requirements and any applicable PRA IRB supervisory statements; and

(ii) where a model rating system has been found not to be compliant, a credible plan for a return to compliance is in place and being completed.

5.3 Firms should agree with the PRA the appropriate ~~SIF~~SMF for providing this attestation.

The PRA would not expect to agree more than two ~~SIFs~~SMFs to cover all the firm's IRB models. In agreeing which ~~SIF~~SMF(s) may provide the annual attestation, the PRA will consider the firm's arrangements for approving rating and estimation processes under CRR Article 189.

(CRR Article 189, 20(6) and ~~CRD Article 3(1)(7)~~4(1)(9))

6 Permanent partial use

…

Non-significant business units and immaterial exposure classes and types

…

6.6 The following points set out the level at which the PRA would expect the 15% test to be applied for firms that are members of a group:

(a) if a firm were part of a group subject to consolidated supervision in the ~~EEA~~UK and for which the PRA was the lead regulator, the calculations in part (a) would be carried out with respect to the wider group;

(b) if a firm were part of a group subject to consolidated supervision in the ~~EEA~~UK and for which the PRA was not the lead regulator the calculation set out in part (a) would not apply but the requirements of the lead regulator related to materiality would need to be met in respect of the wider group;

(c) if the firm were part of a subgroup subject to consolidated supervision in the ~~EEA~~UK, and part of a wider ~~third-country~~non-UK group subject to equivalent supervision by a regulatory authority outside of the ~~EEA~~UK, the calculation set out in part (a) would not apply but the requirements of the lead regulator related to materiality would need to be met in respect of both the subgroup and the wider group; and

(d) if the firm is part of a subgroup subject to consolidated supervision in the ~~EEA~~UK, and is part of a wider ~~third-country~~non-UK group that is not subject to equivalent supervision by a regulatory authority outside of the EEA, then the calculation in part (a) would apply in respect of the wider group if supervision by analogy (as referred to in CRR) is applied and in respect of the subgroup if other alternative supervisory techniques are applied.

6.7 Whether a ~~third-country~~non-UK group is subject to equivalent supervision, whether it is subject to supervision by analogy, as referred to in the CRR, or whether other alternative supervisory techniques apply, is decided in accordance with ~~CRD Article 126~~Regulation 21 of The Capital Requirements Regulations 2013 (as amended by The Capital Requirements (Amendment) (EU Exit) Regulations 2018).

…

11 Definition of default

…

Application of materiality thresholds to banking groups with cross-border entities

11.6A Rule 6.1 of the Credit Risk Part of the PRA Rulebook requires a firm to apply the PRA's materiality thresholds to all of its exposures on a UK individual solo level and, if applicable, UK consolidation group level. When applying materiality thresholds at a solo level, overseas subsidiaries of UK firms are expected to apply the relevant local thresholds. However, the PRA expects firms to apply for a rule modification[5] to modify rule 6.1 in order to also apply local thresholds for these overseas subsidiaries at the UK consolidation group level where, taking into account the local market characteristics, economic conditions, and financial risk, it would be more appropriate to apply the local thresholds than the PRA's thresholds.[6] In respect of certain jurisdictions, the PRA may make available a 'modification by consent' and, if so, would provide details of the modification on the PRA's website. The PRA expects that firms apply for the modification for all jurisdictions in which the local thresholds are more appropriate, and not only those jurisdictions for which they expect the use of local thresholds to reduce capital requirements. Firms should provide supporting information about the appropriateness of local thresholds for all waiver applications.

[6] This also applies to a scenario where UK firms ~~passport into~~operate in other jurisdictions, such that it is a UK firm with an exposures in a different jurisdiction.

…

12 Probability of default in IRB approaches

…

Supervisory slotting criteria for specialised lending

12.36 The PRA expects firms to assign exposures to the risk-weight category for specialised lending exposures based on the criteria set out in the tables in Appendix A. ~~The planned EBA regulatory technical standards on supervisory slotting will further specify these assignments.~~

…

13 Loss given default in IRB approaches

…

Downturn LGD

13.7A As required by the UK Technical Standards on the specification of the nature, severity and duration of an economic downturn[21], firms that identify an economic downturn must examine economic indicators over a historical time-span that provides values that are representative of the likely range of variability in the future, and that this period must have a duration of at least 20 years. The PRA expects that firms should select a historical time-span which enables the identification of economic indicator values that are sufficiently severe to represent downturn conditions. ~~When identifying an economic downturn, the EBA Final Draft Regulatory Technical Standard on the specification of the nature, severity and duration of an economic downturn (EBA/RTS/2018/04)[8] requires that firms examine economic indicators over the previous twenty years. In accordance with the RTS, the PRA expects firms to consider a period longer than twenty years where the values of the economic indicators are considered insufficiently severe during this period.~~

~~[8] This paragraph will only apply once the final RTS has entered into force and applies in the UK. References to the draft RTS should then be read as references to the final RTS published in the Official Journal of the European Union, and, after the end of the transition period, is subject to any amendments made to the RTS under the EU (Withdrawal) Act 2018.~~

[21] As implemented by the Technical Standards (Economic Downturn) Instrument 2021.