UK Finance response to the PRA's DP1/25: Residential mortgages: LGD and PD estimation

31 October 2025

Introduction

1. UK Finance[1] is pleased to respond to the PRA's [DP1/25 – Residential mortgages: Loss given default (LGD) and probability of default (PD) estimation] (the DP).
2. This response reflects contributions from a broad group of our members with retail and commercial portfolios, both banks and building societies. To avoid pre-empting the definition of 'medium-sized firm' discussed in the DP, we use the terminology 'large', 'systemic' and 'non-systemic'. We also delineate between members with existing IRB[2] permissions ('incumbents') and members that do not have IRB permissions ('aspirants').
3. Given the broad nature of the DP, there is a diversity of perspectives among both incumbents and aspirants, and members of differing size and complexity. Within the aspirant group, positions vary from those that have already developed AIRB models – whose views often align more closely to incumbents – to those for whom adoption of the IRB approach remains a longer-term objective. Amongst non-systemic firms, the primary target audience of the DP, views also differ in places between incumbents and aspirants. Where possible, UK Finance's responses to the PRA's questions seek to differentiate between these perspectives and to highlight cohorts of firms among which there is consensus.

Key messages and recommendations

4. **Non-systemic members support the introduction of an appropriately calibrated FIRB[3] approach for UK residential mortgages.** This is viewed as a key step forward in improving proportionality of the IRB framework and supporting competition in the UK mortgage market, without creating distortions relative to AIRB[4] or introducing arbitrage opportunities.
5. Aspirant members generally favour multi-factor eligibility criteria for any FIRB approach, reflecting firms' modelling capabilities and risk management maturity rather than size alone. Incumbent members support optionality to consider FIRB for 'medium-sized portfolios'.
6. **There is broad support for giving firms flexibility to either remain on FIRB on a permanent basis or to transition to AIRB, supported by firm-specific transition timelines and plans** that align with readiness and supervisory expectations.
7. Members emphasise that **LGD calibration is pivotal to the credibility of any FIRB framework**. FIRB LGDs should ensure that the overall risk weights sit clearly between Standardised and AIRB outcomes for comparable risks. In order to achieve this objective, members note that a **reassessment of unwarranted conservatism currently embedded within AIRB models is also required**, particularly for buy-to-let portfolios. Members support an evidence-based FIRB LGD calibration driven by observed loss data.
8. Members also highlight the im**portance of considering how the proposals interact with other regulatory frameworks to ensure coherence and avoid unintended distortions**. This includes linkages with the resolvability assessment framework and MREL,[5] as well as the impacts on Pillar 2 requirements and the implications for in-flight IRB applications from both aspirants and incumbents.

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[1] **UK Finance** is the collective voice for the banking and finance industry. Representing over 300 firms, we're a centre of trust, expertise and collaboration at the heart of financial services, championing a thriving sector and building a better society.
[2] IRB: Internal-ratings based
[3] FIRB: Foundation IRB
[4] AIRB: Advanced IRB
[5] MREL: Minimum Requirement for Own Funds and Eligible Liabilities

LGD estimation: a Foundation IRB approach for residential mortgage exposures

9. **Members support LTV[6] as the key risk driver of LGD under any FIRB approach and segmentation between owner-occupied and buy-to-let exposures. They also advocate differentiation between defaulted and non-defaulted exposures as separate segments** and, in the event origination LTV is used, inclusion of region as an additional risk driver.

10. Significantly all members **favour the use of current/indexed/AVM[7] property valuations** as part of a FIRB approach, given this is aligned to AIRB practice and thus supports greater consistency and comparability between the frameworks, as well as with internal risk management practices. Members highlight the need for clarity on how downturn stresses will be applied to ensure consistency and transparency.

11. Members **support the removal of PPGD[8] reference points given their highly conservative calibration**, provided this is managed through a careful transition and accompanied by clarity on any residual role that remains.

12. We **reiterate the importance of calibration of any FIRB LGD, with members endorsing a loss-data-driven approach** and expressing willingness to contribute industry-wide data to support credible calibration and benchmarking.

PD estimation

13. Members consider that PD Topics 1, 2 and 3 are applicable to all firms, whilst Topics 4, 5 and 6 apply only to non-systemic firms.

14. Given the PRA's indication that not all six topics will be progressed, members would welcome prioritisation of Topics 2 and 3, which are seen as most valuable to address challenges faced by the industry. Topic 1 is not considered a priority area of policy change and there is limited support for Topics 4–6.

15. Incumbents would expect any changes to incorporate these topics within approved hybrid PD models would lead to relatively limited incremental work for both firms and the PRA and could therefore be completed relatively efficiently. This is because existing model calibration, validation, monitoring and stress testing processes can be leveraged, in conjunction with the adjustments to address the considered topics. Notwithstanding the limited support for progressing these, incumbents suggest that if any of Topics 4–6 are implemented, they should be available to all firms to preserve competitive neutrality.

16. Views on Topic 1 (cyclicality calibration cap) are mixed: some members support retaining the 30% cap for stability and consistency, others favour raising the cap (to 40–50%) to reduce undue conservatism, while a third group prefer removing it entirely and managing cyclicality through MoCs[9] to allow greater flexibility and consideration of firm-specific conditions.

17. **We support the PRA's proposals on Topics 2 and 3 regarding the use of GFC[10] data to simplify modelling and reduce RWA[11] variability. However, we challenge the need for any uplift to be applied to GFC data to reflect the early-1990s conditions. Default rates observed in that period are not considered representative of levels expected in future downturns given structural changes have significantly and irreversibly improved the quality of lending in the UK residential mortgage market**. If a

[6] LTV: Loan-to-value
[7] AVM: Automated Valuation Model
[8] PPGD: Probability of Possession Given Default
[9] MoC: Margin of Conservatism
[10] GFC: Global Financial Crisis
[11] RWA: Risk-weighted Asset

supervisory uplift is required by the PRA, it should be transparent, proportionate, and applied at portfolio level (or even at overall RWA level). Moreover, aspirants in particular would value a reference default rate dataset from the PRA that could be utilised where a firm lacks internal data (eliminating the need for backcasting) and a standardised stock-to-flow conversion methodology to reduce unwarranted variability in modelling practices.

18. As noted above, there is limited support for Topics 4–6: Topic 4 (less cyclical drivers) is largely considered a clarification rather than a material policy change and members prefer maintaining flexibility rather than introducing prescriptive requirements to manage scorecard cyclicality. Topic 5 (periodic recalibration) is generally not supported given its inconsistency with the hybrid construct, operational complexity, and the risk of reducing comparability between firms. Topic 6 (TtC[12] approaches) also has limited support due to its complexity, data intensity, and potential to hinder comparability; however, members with EU parents support this proposal to improve cross-border alignment.

19. Overall, **members emphasise that PD and LGD changes must be considered together, alongside Pillar 2 interactions and the overall capital outcomes.** The current 10% mortgages IRB risk-weight floor should be reconsidered in light of any potential updates to the PD framework to ensure consistency and avoid excessive conservatism.

Responses to questions

Q1: Do you have any feedback on how the PRA should define the term 'medium-sized firm' for these purposes?

20. Members highlight that the definition of 'medium-sized firm' should reflect the PRA's overarching policy objectives, the challenges any FIRB framework aims to address, and is heavily interlinked with the eventual framework design. Some members believe that the need for constraints on FIRB availability depends on calibration, how strongly any framework incentivises participation, and whether the regime is permanent or transitory.

21. Members generally support a multi-factor definition of a medium-sized firm, noting that if FIRB is appropriately calibrated, this could best serve the PRA's safety and soundness objectives while ensuring fair competition Members emphasise that the definition should enable firms facing genuine modelling challenges to access a more proportionate IRB framework without materially compromising model development standards. Members would welcome the opportunity to agree with the PRA in advance of any new framework being implemented whether they would meet the definition of a 'medium-sized firm' and what triggers would need to be met for this classification to change.

22. There is broad agreement that asset size is a useful component of any definition of a 'medium-sized firm'. For example, applying a range above the £20bn SDDT[13] ceiling and up to £100bn[14] would create clear parameters for which firms fall within scope. Importantly, any size-based thresholds should evolve over time in line with existing regulatory framework boundaries. However, members note drawbacks to a purely size-based approach, including the creation of cliff edges where relatively small changes in firm size may cause disproportionate eligibility shifts. Members are also concerned that this method overlooks differences in portfolio scale and diversity across firms.

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[12] TtC: Through-the-cycle

[13] SDDT: Small Domestic Deposit Taker

[14] We suggest £100bn as the upper threshold on the basis of published data for the largest UK banks and building societies, which shows a clear demarcation in asset size at this point. This provides a natural cut-off between genuinely medium-sized firms and the large, systemically significant institutions. Possible references are £100 bn (deposits so can be used for assets as a proxy) for firms classified as systemic firms for Resolvability assessment Framework and £105 bn lending for Bank Capital Stress Test.

23. Some aspirants favour an eligibility framework not based on asset-size or similar criteria. These firms are of the view that thresholds based on asset size or revenue are arbitrary, will require regular updates, and that eligibility for any FIRB approach for residential mortgages should instead be open to all firms that do not opt into the SDDT regime and based on the firm's modelling capabilities. Members note that, in practice, very small firms are highly unlikely to find developing an FIRB approach economically viable.

24. In determining the eligibility criteria for any FIRB regime, some incumbents urge the PRA to consider other thresholds that impact capital requirements (e.g. the resolvability assessment framework or MREL thresholds) to support comparability and prevent potential market distortions, such as situations where firms benefit from lower credit risk capital requirements under FIRB without being subject to bail-in capital requirements.

25. Notwithstanding the above, some incumbents believe eligibility for any FIRB approach for residential mortgages should be open to all firms, with framework availability determined by portfolio size or nature rather than overall firm size (i.e. allowing FIRB use for 'medium-sized portfolios' or 'non-modellable/low data portfolios' from an LGD standpoint). This would better align the treatment with the specific modelling challenges that arise in certain UK residential mortgage portfolios, such as acquired, runoff or small portfolios. Aspirants, however, note the risk that this approach could disproportionately benefit larger incumbents that have greater scale, resources, and modelling capabilities to develop AIRB models, and suggest that the existing PPU[15] framework already caters for such smaller and non-modellable portfolios within AIRB firms.

26. With respect to firms that are part of a wider group, incumbent IRB members note that certain subsidiaries or divisions may face modelling challenges and have portfolios that would be well suited to FIRB treatment, suggesting that eligibility could in principle be applied at the subsidiary level. However, several non-systemic and aspirant IRB members caution that allowing this could undermine the intent of the regime, as subsidiaries of large groups benefit from the wider organisation's capital, infrastructure, and modelling expertise. Extension of any FIRB regime to subsidiaries of large groups could lead to an uneven playing field, create opportunities for regulatory arbitrage, and increase supervisory complexity. Moreover, the PPU regime already provides UK subsidiaries with IRB permissions with an avenue to maintain the Standardised approach for non-material business segments.

27. Members additionally highlight the need for further clarification on how any UK residential mortgages FIRB regime would apply in practice to firms with parent entities in the EU. Given the EU regulation mandates AIRB for retail exposures, it is unclear whether ECB[16]-supervised firms would be permitted to adopt an FIRB regime and members note the potential for the proposals to create additional regulatory burdens for dual-regulated firms.

28. On the other hand, some non-systemic members note that operating on a global or EU-wide basis, maintaining multiple subsidiaries or comprising several divisions offering a diverse range of residential mortgage products are characteristics not expected to readily align with a true 'medium-sized firm.'

Q2: Do you have any feedback on the barriers that firms may face when modelling LGD in relation to residential mortgage exposures? Are there any specific barriers for medium-sized firms?

29. Members highlight that firms encounter a range of barriers when modelling LGD for residential mortgage exposures in accordance with the PRA's expectations. In particular,

[15] PPU: Permanent Partial Use
[16] ECB: European Central Bank

a significant challenge relates to the availability of loss data reflecting downturn conditions. Members note that some non-systemic firms may hold sufficient repossession, sale and loss volumes, but without downturn observations it is difficult to demonstrate performance across the full credit cycle. This limitation constrains firms' ability to construct models that remain resilient under stress scenarios. Members also note that the current requirements to assume significant house price shocks constrain firms' ability to make full use of more recent, high-quality data. On the other hand, other non-systemic firms have long data history and robust volumes in the downturn, but lower possession/sales in benign recent periods can lead to non-representative outliers impacting components.

30. Members also note that these challenges are relevant in the context of a transitional FIRB regime, as discussed further in Question 7. Without a clear pathway to resolving the LGD modelling challenges firms face, there is a risk that unresolved issues are simply deferred, potentially resulting in larger systemic challenges in the future. However, this assumes a transitional approach is adopted rather than the option to have a permanent FIRB regime. The expectation in this regard is that the FIRB regime will have appropriately calibrated LGD outcomes to reflect noted limitations.

31. In some cases, members observe that these challenges may arise not solely from the policy framework itself, but also from the way it has been interpreted and applied through technical review sessions. The combination of a principles-based regulatory framework, evolving and sometimes unclear regulatory expectations, and more prescriptive model review feedback in applying the framework in practice has, at times, contributed to uncertainty, inconsistency, and additional operational complexity for firms. Some members highlight that a key challenge in the recent AIRB mortgage model review process has been the number of firms undergoing review simultaneously coupled with the evolution of supervisory feedback as large firms' models were finalised and the PRA gained greater visibility of their operation in practice. Consequently, the process became particularly protracted for non-systemic incumbents, heightening resource and cost pressures for these firms.

32. Specifically, non-systemic firms with established IRB rating systems note that the challenges experienced may not primarily relate to firm intent or capability of the firm, but rather to the need to navigate evolving supervisory expectations. In this regard, additional challenges are noted in relation to products other than traditional owner-occupied mortgages, which the current IRB regime is geared towards. Members suggest that clearer guidance and more consistent supervisory implementation (particularly for non-vanilla mortgage products) and feedback could help to reduce barriers and ease some of the challenges currently encountered.

33. Additionally, members emphasise the importance of considering how portfolio-level LGD (and risk-weight) outcomes compare across portfolios – for example, between owner-occupied and buy-to-let mortgage exposures, or between commercial real estate and unsecured exposures. It is important the PRA assesses whether AIRB-derived LGD parameters are proportionate and grounded in observed loss experience, or whether they may be unduly conservative.

34. Additional barriers in relation to the IRB accreditation and model feedback and approval processes noted by members have been summarised in response to Questions 16 and 25.

Q3: Do you have any feedback on whether the PRA should introduce an FIRB approach for residential mortgages, and on the costs and benefits of this?

35. Members generally support introducing an FIRB approach for residential mortgages (on the basis of appropriate segmentation and calibration based on actual loss experience). In particular, aspirants and non-systemic members strongly believe this would offer a more pragmatic solution for firms looking to migrate from the Standardised approach and could

significantly improve access to the IRB approach for this exposure class across medium-sized firms (subject to how 'medium-sized firm' is defined), thereby promoting competition.

36. Some aspirant/non-systemic members question whether a FIRB approach would address the extent and/or nature of the challenges faced by the industry today and note that amendments to the PD framework are also critical to alleviating the challenges firms face in relation to reflecting default experience from the early 1990s. Any FIRB approach will therefore need to consider overall Pillar 1 requirements (across both from PD and LGD) and Pillar 2 impacts.

37. However, several large incumbents do not believe that introducing a FIRB approach for residential mortgages would be the most effective way forward. Given the extensive data available on mortgage portfolios, there is a view that a FIRB approach could undermine the benefits of internal modelling by removing the ability to differentiate based on firms' own recovery and loss experiences.

38. Some incumbents also have concerns that an FIRB approach could weaken incentives for firms to understand loss dynamics, portfolio and collections performance, and potentially reduce portfolio insight, governance and changing incentives. However, others noted that this would be mitigated by the fact that, even under an FIRB approach for regulatory capital, firms would continue model and monitor LGD internally for other purposes such as for IFRS 9[17] and stress testing, and IFRS 9 is subject to external audit. The risk of diminishing incentives to strengthen portfolio analytics and insight could also be mitigated by ensuring FIRB was only available on a transitional basis.

39. Members note that calibration of any FIRB approach is critical to its ability to achieve the objective of helping medium-sized firms achieve permission for residential mortgages portfolios. In this regard, members note that the existing AIRB LGD framework already has significant conservatism embedded (especially for buy-to-let exposures), and an FIRB position that is more conservative again risks overstating risk weights and disconnecting capital levels from underlying losses. However, members also note that FIRB needs to be carefully calibrated to complement the existing AIRB and Standardised approaches and avoid creating arbitrage opportunities for firms to select FIRB and achieve lower capital requirements than firms using the AIRB approach. Finally, it is relevant to consider the FIRB LGD values for corporate exposures under the current framework, whereby senior unsecured exposures to non-financial sector corporates receive a 40% LGD and a 100% LTV commercial real estate mortgage exposure would receive a 28% LGD.[18]

40. Additionally, aspirants recognise specialist products (e.g. high-net-worth and buy-to-let lending) as an area of difficulty, with the current AIRB framework not offering a workable solution in some cases. Members suggest that any FIRB approach should give the PRA flexibility to account for specialist products to avoid inappropriate calibrations for such products. As part of calibration of any FIRB approach, members with specialist products strongly recommend the AIRB LGD profile for specialist products is revisited for appropriateness when considering the commercial real estate FIRB LGD values currently in place.

Q4: Do you have any feedback on the potential removal of the PPGD reference points?

41. Members support removal of the PPGD reference points. However, members note the need to ensure any removal is managed carefully to avoid unintended consequences for firms with limited data. Some members also suggest that the PRA clarify whether its intent is outright removal or whether adjusted values could still play a role in certain contexts

[17] IFRS 9: International Financial Reporting Standard 9, Financial Instruments

[18] Per Articles 161 and 230 of the near-final draft Credit Risk: Internal Ratings-Based Approach (CRR) Part of the PRA Rulebook and equivalent provisions in UK CRR.

(e.g. in the AIRB framework or as part of a component-based/formulaic FIRB construct, either directly or in its calibration).

42. Members note that reference points were historically set through a conservative lens. While few firms make extensive use of the reference points, some non-systemic firms have been encouraged to use them, creating inconsistencies and inflating LGDs. In calibrating PPGD within any FIRB framework, to the extent relevant, members suggest the PRA considers utilising observed PPGD data.

43. Finally, under the Basel 3.1 near-final draft rules, the AIRB regime will operate under a principle of 'material compliance'. Members request clear guidance on how this will be assessed if reference points are withdrawn, alongside proportional treatment to avoid disproportionate burdens on non-systemic firms. From a timing perspective, members would welcome clarity in relation to expectations to consider the reference points in the intervening period before any formal removal from the framework.

Q5: Do you consider there to be other retail exposures for which the PRA should consider developing an FIRB approach?

44. Members note that residential mortgages represent the retail exposure type with the largest and most robust dataset, yet even in this segment there are material barriers in collecting and maintaining sufficient possession, sale and loss data for LGD modelling. The data challenges in other retail portfolios are likely to be even more prevalent and structural, albeit less complex. Members therefore agree with PRA's prioritisation of residential mortgages as the most suitable starting point that would serve as a 'proof of concept', enabling both firms and supervisors to test a FIRB retail framework for a portfolio where both the barriers to and the potential benefits of gaining IRB permissions are significant.

45. Members suggest that once there is evidence that FIRB can be implemented effectively for mortgages, the PRA may wish to consider other portfolios. Asset finance and motor finance represent examples of where firms face meaningful data limitations that hinder the development of robust IRB models and may therefore benefit from an FIRB option.

46. By contrast, members did not consider unsecured retail exposures to be a priority for FIRB development. Data constraints and modelling challenges in this space are typically less significant; therefore, the incremental benefit of a FIRB approach would be expected to be limited (though some members note that there is less industry data available for modelling unsecured portfolios, meaning where firms have historic data limitations this creates challenges).

47. The challenges in other portfolios are often more structural and would not be resolved through FIRB alone. Accordingly, members agree that the priority should remain on residential mortgages, while remaining open to further dialogue on whether carefully targeted extensions (e.g. asset finance and motor finance) might be appropriate in future.

Q6: Do you agree that any FIRB approach should only be made available to medium-sized firms?

48. Members note that whether FIRB should be limited to medium-sized firms ultimately depends on how 'medium-sized' is defined, as the boundary will determine eligibility and whether the framework achieves an appropriate balance between proportionality and risk sensitivity, whilst promoting competition, and maintaining the right broader incentives. Incumbent IRB members also question whether eligibility should be based on medium-sized firms as a whole or on medium-sized portfolios within firms (e.g. small, acquired books) as noted in our response to Q1 above. However, some aspirants suggest that any

FIRB approach should be limited to medium-sized firms if the PRA's objective is to allow more firms to achieve IRB permissions.

49. Members emphasise that FIRB should not create competitive advantages over AIRB; ideally, any unwarranted conservatism in AIRB should be removed, rather than exacerbating conservatism in FIRB. Accordingly, some non-systemic and aspirants believe that larger firms with the capability to develop AIRB models should not benefit from reduced requirements by reverting to FIRB (in line with paragraph 2.11 of DP1/25 – 'the PRA is minded to not allow larger firms to apply this approach'), and that the framework should be carefully designed to avoid regulatory arbitrage and preserve a level playing field.

50. Some members reiterate that eligibility should be considered at subsidiary level, noting that subsidiaries or divisions of larger firms may operate with genuine independence and face the same modelling barriers as standalone medium-sized firms. In such cases, a carefully defined FIRB pathway could be appropriate, provided safeguards are in place to prevent inappropriate extension of treatment to the wider group. Other members are of the view that the current PPU and roll-out framework already appropriately caters for such challenges.

Q7: Should any FIRB approach be on a permanent basis or a temporary basis? If a temporary basis, how long should the transition period be?

51. Non-systemic members believe that firms should retain the option to remain on FIRB indefinitely where this represents the most proportionate and realistic outcome given the firm's data and modelling capabilities or to ultimately migrate to AIRB where this is an attainable and desired pathway. The respective calibrations of the FIRB and AIRB regimes should ensure there are appropriate incentives for transition to AIRB where feasible. An optionally permanent FIRB regime would best support competition and make IRB available to firms for which the investment in advanced modelling would ultimately be disproportionate, without preventing other firms from transitioning to AIRB where attainable.

52. Alternatively, some large members are of the view that any FIRB approach should be introduced as a temporary, transitional framework, enabling firms to make use of the approach as part of a move to AIRB within realistic timelines.

53. Both systemic and non-systemic members are of the view that any transitional period should not be fixed uniformly across all firms but rather should be linked to each firm's ability to address data, modelling and governance gaps, as agreed with the PRA as part of the firm's roll-out plan (or Module 5 for aspirants). This would recognise that firms will progress at different speeds depending on the maturity of their portfolios and infrastructure, with supervisory reviews playing a key role in validating progress and setting expectations.

54. Whilst members hold a range of views on the design of any FIRB framework, there is a clear consensus that any FIRB calibration must not be more beneficial when compared to AIRB for the same product type and risk profile. Without such a calibration and alignment of capital incentives, there is a risk of undermining the policy objective. At the same time, members emphasise that firms choosing to invest in AIRB modelling should not be disadvantaged as a consequence of doing so.

Q8: In light of your answer to Question 7, should medium-sized firms with AIRB permission be able to revert to an FIRB approach?

55. Members consider that the option for medium-sized firms with existing AIRB permissions to revert to FIRB should be approached with caution. Allowing broad reversion could undermine incentives to maintain advanced models and weaken prudential outcomes.

56. However, members acknowledge there may be exceptional circumstances where reversion is reasonable – e.g. where regime changes or recalibrations make existing AIRB models unsustainable or where sub-portfolio-specific data limitations or representativeness challenges emerge – and suggest that the PRA should consider these on a case-by-case basis, under a framework similar to that in place for PPU. Reversion should not be used by firms to avoid maintaining AIRB models or to 'cherry pick' opportunities to attain more favourable capital outcomes and, therefore, any availability should be subject to close supervisory review and monitoring.

57. Aspirants targeting an accreditation timeframe likely to predate the inception of any FIRB framework face an additional challenge while the outcome of this consultation remains uncertain. The lack of clarity on potential future FIRB availability and calibration – including any potential reversion – creates difficulty in committing resources to ongoing AIRB model development efforts. Members consider it important that the PRA provides guidance on how any FIRB approach will interact with in-flight hybrid PD and LGD model submissions from both aspirant and incumbent firms.

58. In parallel, members consider it important that the PRA ensures its approach to IRB under Basel 3.1 remains practical and proportionate. The notion of 'material compliance' should be retained and applied consistently, reducing the risk that firms feel compelled to revert to FIRB because of technical or operational obstacles.

Q9: Should LTV be the only risk driver used to determine LGD for residential mortgage exposures under an FIRB approach? Are there any other risk drivers you consider should be included, and why is that the case?

59. Members recognise the need to balance improved risk sensitivity against excessive complexity. There is consensus that only a limited number of simple, observable, non-cyclical drivers should be introduced, ensuring broad accessibility for firms without excessive data demands that would better align outcomes with risk.

60. Members are of the view that LTV is the key driver of LGD and support LTV being the sole risk driver (alongside the segmentation criteria discussed in response to Question 12), in view of creating a simple, transparent and comparable FIRB regime, aligned to the existing corporate FIRB approach.

61. Members note that a key consideration in relation to the use of LTV as a risk driver is whether this is indexed LTV or origination LTV. As noted in paragraph 63 below, the majority of members see region as a risk driver given it can have a significant influence on recoveries. In the event the PRA chooses to adopt an origination-LTV based approach that does not enable regional HPI[19] to be reflected in LTV values, members would suggest region is incorporated as a separate risk driver within any FIRB LGD (though note that this will increase driver complexity).

62. Members also note that distinguishing between owner-occupied and buy-to-let lending is regarded as fundamental (as discussed further in Question 12 as a standalone segment). Members additionally note that default and not-in-default exposures are seen as key segments for the purposes of determining any FIRB LGD – this is discussed further in response to Question 12. Repayment structure (interest-only versus capital-repayment mortgages) may also be a relevant risk driver given its implications for customer behaviour and recoveries; however, this is likely to overlap substantially with the owner-occupied and buy-to-let segmentation and is therefore not considered necessary as a separate driver.

[19] HPI: House Price Index

Q10: Which approach to valuation should be used for any FIRB approach for residential mortgage exposures?

63. Substantially all members prefer using current/indexed/AVM valuations in the determination of LTV, consistent with the AIRB methodology. This is seen as more reflective of actual risk and more comparable and practical to calibrate against AIRB outcomes. It is noted that relying on origination valuations could make it difficult for the PRA to maintain consistency and transparency across FIRB and AIRB frameworks. Moreover, members highlight that, in line with current practices of incumbent IRB firms, property values can be indexed using regional HPI, thereby capturing the differences in valuations and recoveries by region.

64. A small minority of members, however, argue that aligning with the valuation requirements under the revised Standardised approach for firms may better serve the objectives of simplicity and improving the accessibility of IRB in the context of a permanent FIRB regime.

65. Several incumbents query how the downturn calibration would interact with whichever valuation method is chosen. If current valuations are used, clear guidance would be needed on applying stress adjustments, such as the combined 40% average house price reduction (i.e. 25% peak-to-trough fall plus forced-sale discount) to ensure consistency, noting the difficulty of calibrating these to the economic cycle under FIRB. An origination-based approach aligned to Standardised could be less prudent than applying a downturn stress to indexed LTV; therefore, if an origination-valuation-based approach is adopted, either a stress needs to be applied to maintain parity with AIRB, or this needs to be factored into calibration of FIRB LGD. Alternatively, an origination-valuation-based approach might embed conservatism but would risk becoming outdated and difficult to reconcile with observed market values over time.

Q11: What approach to valuation should be used for any FIRB approach for second charges and self-build exposures?

66. Members did not identify any major obstacles or unique challenges that would require special treatment under an FIRB framework with respect to second charge and self-build exposures specifically. Members generally feel that the logic from whichever valuation methodology is adopted could be carried across to these segments.

Q12: Do you have any feedback on whether it would be appropriate to segment any FIRB approach for residential mortgages by BTL and OO? Are there other segmentations that the PRA should include?

67. Members agree that segmentation between owner-occupied and buy-to-let lending is appropriate and should be a core element of any FIRB approach. There is strong consensus that the two product types exhibit materially different behaviours, both in terms of borrower incentives and recovery practices, and that this distinction should be reflected explicitly in the framework. Some members have an expectation that, whilst underlying drivers may differ between owner-occupied and buy-to-let, FIRB LGD should be similar across these products (for a given LTV band, etc).

68. Members stress the importance of ensuring an appropriate calibration across these segments that is proportionate and reflective of lenders' observed loss experience. This is considered critical to supporting the PRA's competition agenda and preventing unduly conservative outcomes for medium-sized firms with specialist portfolios.

69. Beyond buy-to-let and owner-occupied, members highlight in-default and not-in-default as key additional segments to be included within any FIRB LGD construct. This conceptual separation is important to ensure risk sensitivity, the conditionality that LGD represents and comparability across firms are appropriately maintained and reflected.

70. Members would welcome clarity on the PRA's intentions regarding FIRB LGD for defaulted exposures, noting that no RWAs apply within Corporate FIRB, as well as whether an expected-loss capital deduction/add-back framework would be a feature of any residential mortgages FIRB approach.

Q13: Do you have any feedback on what collateral eligibility criteria should be included in any FIRB approach?

71. Members agree that strict collateral eligibility criteria are necessary for firms to recognise the benefit of collateral within the FIRB framework. There is consensus that the PRA's proposal to align with the requirements under the existing Foundation Collateral Method is sensible and largely uncontroversial.

72. Members note that such criteria should cover the fundamental safeguards already embedded in sound risk management practices. These include legal certainty of charge over the property, the requirement for appropriate insurance, and robust valuation processes. Members emphasise that these measures are already standard elements of prudent mortgage underwriting and risk control, and therefore their inclusion in the FIRB rules would present limited additional burden.

73. However, members note that the requirement that "the firm monitors that the property collateral is insured against the risk of damage" is overly onerous. Typically, this is performed at the outset of a mortgage as part of conveyancing, and this should be sufficient.

Q14: Do you have any comments on the high-level approach to calibrating supervisory LGD values?

74. Members agree that calibration of supervisory LGD values represents one of the most challenging aspects of the FIRB framework, given the need to both strike a balance between simplicity and risk sensitivity and to ensure appropriate risk-weight outcomes vis-à-vis the Standardised and AIRB approaches. In this regard, members highlight the significant conservatism embedded in residential mortgage LGDs (and PDs) under hybrid AIRB models and the resultant narrow available range between AIRB LGDs and implied Basel 3.1 Standardised LGDs in which to calibrate FIRB LGDs, particularly for buy-to-let and higher LTV exposures.

75. In relation to framework design, members note the trade-offs between adopting a simple look-up table, or formulaic or component-based approach for determining LGD under a FIRB approach. Non-systemic members favour simple LTV-based matrices for ease of application and believe this approach would best align to the PRA's objective of lowering the barrier to entry to IRB and avoiding undue complexity. Within this approach, aspirants favour the use of granular LGD bands (e.g. 10% bands) to achieve risk sensitivity. Non-systemic incumbents favour simplicity (i.e. fewer bands) and caution against making FIRB so risk sensitive it undermines incentives to move to AIRB and diminishes the benefits AIRB firms receive, potentially hampering competition.

76. Some incumbents suggest that a lookup-table-based approach could oversimplify outcomes, create perverse incentives around bucket thresholds, and overlook material portfolio and segment differences evident in loss data. In contrast, a formulaic or component-based method, more closely aligned with AIRB LGD modelling components, could enhance risk sensitivity, transparency and comparability, consistent with the proposal for FIRB for mortgages as a transitional framework. However, some aspirants believe such approaches risk introducing unnecessary complexity and could undermine the very objective of an FIRB regime.

77. Incumbents and aspirants who have submitted AIRB models highlight that significant investments have been made by existing IRB (and mature aspirant) firms in developing

and/or obtaining approval for their mortgage rating systems, particularly in the following areas:

- Capabilities in IRB modelling, validation, model risk management and regulatory interpretation activities (including regulatory reporting);
  IRB data capture and infrastructure capabilities and sophistication;
- Embedding of operational processes and controls;
- Ongoing model monitoring, maintenance, and governance; and
- Hiring, developing and retaining skilled analytical resources.

The significant costs associated with these areas and activities should be reflected appropriately when designing and calibrating any alternative policy option that aims to simplify the IRB approach, thereby ensuring a level playing field.

78. Members see value in gathering industry-wide loss data, both to inform FIRB calibration and to evidence the level of disconnect between observed losses and current AIRB LGDs and highlight areas where AIRB conservatism may warrant reconsideration to avoid creating distortions or competitive disadvantages. Furthermore, some members see value in the PRA performing its own comparison of residential mortgage risk weights across BCBS jurisdictions to ensure UK firms are not being required to hold disproportionally high capital levels for equivalent products and risk profile.

79. Some members feel that any FIRB LGD values should be purely informed by data, rather than artificially pegged to sit somewhere between the Standardised and AIRB approaches and that FIRB LGD values should also reflect the material changes in the UK regulatory environment. The requirement to use repossession as a last resort combined with Consumer Duty standards, especially for customers in financial difficulty, have resulted in much lower levels of repossessions, extended support offered to customers and increasing evidence of better outcomes.

80. There is a broad recognition that calibration cannot be separated from wider considerations of scope, segmentation and data availability as well as PRA's potential changes to PD requirements for residential mortgages. Members note that recoveries and collections processes differ significantly across firms, which makes standardisation difficult. The consensus amongst the majority of members is that any chosen approach must balance risk sensitivity with accessibility, avoid creating arbitrage opportunities, and ensure that FIRB outcomes sit credibly between Standardised and AIRB levels, across product types and the industry.

Q15: Do you have any quantitative or qualitative evidence the PRA should consider regarding the approach to calibration, in particular for reflecting downturn conditions? This will inform the PRA's decision on whether to undertake a more structured, one-off data collection exercise.

81. Members acknowledge that robust evidence is essential for credible calibration, particularly when reflecting downturn conditions. There is support for the PRA to undertake a structured, one-off data collection exercise to support calibration.

82. As noted in response to Question 14 above, members highlight the substantial conservatism built into residential mortgage LGDs (and PDs) under hybrid AIRB models, which causes both a substantial disconnect between observed and modelled loss outcomes, and results in there being a very limited range between AIRB LGDs and implied Basel 3.1 Standardised LGDs available for calibrating FIRB LGDs. Therefore, members believe that achieving an appropriate FIRB LGD calibration would be challenging without changes to existing AIRB expectations (including PD requirements) to enable the creation of an appropriate differential between Standardised, FIRB and AIRB risk-weight outcomes.

83. Several members, primarily incumbents, posit that calibration should be grounded in observed loss data. Members highlight the disconnect between actual losses experienced

by firms, even through periods of severe stress such as the GFC, and the conservative LGDs currently embedded in AIRB models. In many cases, capital held against mortgage exposures is now many multiples higher than the actual losses incurred in even the worst years in recent history. Members argue that calibration should be anchored to such evidence, with regulatory conservatism applied only if absolutely essential and evidenced by data and if so, as a transparent and proportionate overlay.

84. Incumbents note that the definition of downturn conditions remains ambiguous in practice. Absence of clear and consistent expectations could result in the PRA cherry-picking the most adverse outcomes from different periods (which has been the case for firms going through the hybrid PD approval process to date), for example, the GFC, COVID-era or another more recent stress period, leading to inconsistent results. Members suggest the need for a clear and consistent application of the downturn definition, similar to the approach taken by the EBA, to avoid inconsistencies and ensure comparability.

85. Members raise concerns about the feasibility of historical data collection. While many firms can provide data back to the 2008 crisis, going further is seen as unrealistic and inappropriate given the lack of representativeness of the market structure and conditions observed in prior periods compared to today's market. Members suggest that calibration exercises should therefore focus on periods where reliable and representative industry data is available.

Q16: Do you have feedback on any other elements the PRA should consider when designing an FIRB approach for residential mortgage exposures?

86. Members note the need to consider adjustments to both PD and LGD requirements together in determining any FIRB calibration. Members urge the PRA to consider the calibration and impact of changes to PD and LGD requirements in tandem, to ensure coherent and balanced risk weight outcomes. The same applies in relation to Pillar 2 requirements, where members stress the importance of maintaining a balanced approach and avoiding the disproportionate erosion of any capital benefits gained through FIRB accreditation.

87. Some members caution against a uniform solution applied indiscriminately across all mortgage products, noting that exposures such as buy-to-let, owner-occupied, or specialist portfolios can behave very differently. The product-specific differences should be reflected in the framework without adding unnecessary complexity. However, other members note that while risk management practices differ, the end loss profile is comparable meaning final LGD calibration should be similar and should not excessively penalise products such as buy-to-let, as is the case today.

88. Members recognise that economic and legal environments change over time, and agree that regulatory stability is important, any FIRB framework should permit recalibration when evidence shows supervisory values no longer reflect observed risk, or where AIRB and FIRB LGDs converge for comparable products and risk profiles. Simultaneously, members emphasise that firms value certainty when making investment and methodology choices, noting that any FIRB recalibration for residential mortgages should be infrequent, well-signalled and maintain a conservative calibration relative to AIRB outputs.

Q17: Do you have any feedback and supporting evidence on the costs and benefits of revising or removing the 30% cyclicality calibration assumption cap, including on what impact it might have on capital requirements?

89. Members have a range of views in relation to the PRA's specific proposals on the 30% cyclicality calibration cap. Several members also raise concerns with the cyclicality formulation and note a lack of clarity in relation to terminology used in this regard.

90. Several aspirants and incumbents favour retaining the existing 30% cap, seeing it as a pragmatic and stabilising anchor given significant uncertainty remains regarding the behaviour of hybrid models across the economic cycle. These members view the current level as conservative but appropriate, helping reduce the risk of model monitoring breaches and performance concerns. They argue that if the cap were raised, for example to 50%, firms could later find their models exhibiting less cyclicality than assumed, triggering potential remediation. Retaining the cap therefore provides regulatory and operational stability in the short term.

91. Other primarily incumbent members take the view that the current conservative level of the cap contributes to higher capital requirements and limits the risk sensitivity of models. They argue that while the 30% cap provides a degree of stability, its level of conservatism may no longer be proportionate in view of enhancements in modelling standards and regulatory oversight. From this perspective, revisiting the calibration could enable a more balanced approach that reflects both prudence and risk sensitivity. Modestly increasing the cap to 40–50% would help alleviate unnecessary conservatism while maintaining a degree of consistency across firms. These members also note that the existing 30% limit can encourage TtC adjustments that unintentionally heighten cyclicality, ultimately leading to inflated risk weights and reduced model efficiency.

92. Some incumbents suggest that the cap could be removed entirely, with cyclicality instead addressed through the MoC framework. This approach would allow firms to reflect their own true estimates of cyclicality in the model calibration, as well as the level of uncertainty around these estimates (which will be different for different firms, and more conservatism should be applied where there is less certainty in an estimate). It could also prevent more predictive but inherently cyclical models from being disproportionately constrained, while ensuring that conservatism remains applied in a transparent and proportionate manner.

93. Some members, across incumbents and aspirants, highlight international differences in regulatory treatment, noting that European frameworks do not impose a comparable cyclicality requirement. For subsidiaries of EU-headquartered groups, maintaining separate calibrations (and, therefore, entirely separate models) creates operational inefficiencies.

94. Incumbent IRB members also note that any change to the cyclicality assumption (or indeed to the requirements considered in Topics 2 and 3) should be considered alongside a review of the 10% risk-weight floor. They note that the current risk-weight floor was established under the 30% cyclicality assumption and based on early-1990s stress period, and that if this risk-weight floor is retained without a corresponding recalibration it may constrain the impact of any increase to or removal of the cyclicality cap.

95. Overall, members agree that the potential capital impacts of altering or removing the cap are significant. However, they also acknowledge that without addressing the broader methodological limitations in the measurement of cyclicality, adjustments to the cap alone may provide limited benefit and could compromise model comparability across firms. Changing the cyclicality calibration assumption cap is therefore not considered a priority area of reform for members.

Q18: Do you have any feedback and supporting evidence on a potential simplification to the hybrid PD calibration where firms would use data including the GFC and apply a supervisory uplift?

96. Members support the proposal to simplify hybrid PD calibration by allowing the use of data that includes the GFC. The primary benefit of this would be eliminating the need for backcasting for the majority of firms and thus removing unnecessary modelling complexity and reducing unwarranted RWA variability.

97. Members challenge the requirement for long-run average PD to reflect economic conditions equivalent to those observed in the UK during the early 1990s on the basis that the UK mortgage market at that time was fundamentally different to today. This is driven by a number of structural market and product changes that mean today's mortgage market is significantly lower risk and default rates are highly unlikely to ever reach the levels observed in the early 1990s. Key structural market changes include:

- **Fixed rate vs. variable rate loans:** The majority of mortgages in the early 1990s were variable rate; the reverse is now true, with 85% of all new originations now on a fixed-rate basis. Fixed-rate loans insulate borrowers from a sudden interest rate increases and provide time for them to adjust finances to meet increased repayment costs. The benefit of this has been observed during the recent interest rate tightening cycle.
- **Enhanced regulations:**
    - Introduced from 2004 within the FCA[20] Handbook, the MCOB[21] rules govern how mortgage lenders and other firms conduct business with customers on home finance products like mortgages. MCOB is designed to protect consumers and ensure fairness and stability in the market and establishes rules on how firms conduct business with customers, including specific guidance on advised sales, execution only sales, and a framework for responsible lending practices.
    - The MMR,[22] which implemented additional MCOB rules in 2014, centred on preventing unaffordable mortgage lending via stricter checks on income and expenditure, the removal of self-certification, the mandating of advice for specific transactions and loan types, and imposing limitations on interest-only lending. This also included a requirement for lenders to assess affordability at stressed rates, supporting improved creditworthiness.
    - Additionally, in 2014 the FPC[23] recommended that no more than 15% of new residential mortgage lending should be at LTI[24] ratios at or above 4.5. This was subsequently formally codified and monitored by the PRA and FCA.
    - The Mortgage Credit Directive (2015) saw the mandated provision of enhanced information to support customer understanding (standardisation of ESIS[25] documentation and binding offers); and
    - Consumer Duty, introduced in 2023, supplemented existing regulation and provided a new overarching standard of care to ensure that lenders continue to deliver good outcomes for retail customers.
- **LTV profile:** Approximately 30% of the loans written in 1993 were above 90% LTV, compared to less than 10% written today, with the share of outstanding stock above 90% LTV sitting at approximately 1% (taking into account house price growth). For buy-to-let lending specifically, LTVs and risk appetite have become more conservative following the introduction of PRA Supervisory Statement SS13/16 *Underwriting standards for buy-to-let mortgage contracts*.
- **Lower arrears and repossessions:** Today's rates are significantly lower than in the 1990s driven (in part) by the above changes to lending practices and regulatory landscape, and improved household financial resilience.
- **Credit assessment and analytics:** Credit assessments in the 1980s and early 1990s were rudimentary and largely manual, utilising limited customer variables. Since the early 2000s, credit bureau scores and data have been widely integrated in mortgage credit decisioning. Significant advances in data-led portfolio management, behavioural scoring and oversight at lender- and market-level have continued since this time.

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[20] FCA: Financial Conduct Authority
[21] MCOB: Mortgages and Home Finance: Conduct of Business Sourcebook
[22] MMR: Mortgage Market Review
[23] FPC: Financial Policy Committee
[24] LTI: Loan-to-income
[25] ESIS: European Standardised Information Sheet

98. The impact of the changes noted above is corroborated by the actual loss experience of mortgages written prior to the GFC and those written since and, in particular, post the MMR. Members observe a substantial reduction in loss experience for vintages written post the MMR, which reasserts that the approach to modelling mortgages has become detached from the risk posed by the underlying lending.

99. As the changes noted above have structurally (i.e. permanently) decreased the level of risk significantly since the early 1990s, members question whether an uplift to GFC data is necessary at all.[26] Members believe the GFC represents a credible and sufficiently severe downturn period for the purposes of long-run average PD calibration and better reflects the structural features of the modern mortgage market than the 1990s.

100. Members additionally note that buy-to-let mortgage products were only officially launched in the UK in 1996, meaning limited to no representative data exists from the early 1990s and backcasting to this period is nonsensical for buy-to-let (and other products derived after this time).

101. Members also caution that applying a supervisory uplift to GFC-era data to reflect the severity of the early 1990s downturn may produce overlapping prudence within the framework. This embeds additional conservatism in the Pillar 1 calibration, while firms may be required to hold additional capital to ensure they can withstand a severe but plausible stress scenario under Pillar 2B. Moreover, conservatism is embedded in the IRB risk-weight formula by design through both the 99.9th-percentile confidence level and the non-linear relationship with PD, meaning capital increases non-linearly as PD rises. This means that further uplifts to PD risk producing capital outcomes materially above those implied by actual portfolio risk. Members believe that the PRA should examine the effect of stressing the mortgage book through either consideration of the 1990s conditions in hybrid PD models and the Bank Capital Stress Test. Members surmise that the latter provides a more effective and efficient route to stress the mortgage book, as it allows for the dynamic definition of a stress rather than a static requirement.

102. In light of the above, members caution that if the PRA opts to require firms to apply a supervisory scalar to GFC experience, this should be calibrated to reflect how the changes noted in paragraph 97 have decreased the level of risk in the market. Members question how any uplift mechanism would operate in practice. We note that:

- Applying uplifts at portfolio level is viewed as simpler and more proportionate than grade-level adjustments, which would be difficult to calibrate or standardise given differences in grade structures and distributions across firms. Alternatively, some incumbents favour introducing a simple, transparent uplift at RWA level rather than at PD level to avoid interference with modelling and monitoring.
- The definition of the economic cycle used for calibration should be more explicit, as previous exercises have shown that determining cycle start and end points can be subjective and time-consuming and lead to unwarranted variability.
- Greater clarity is needed on how the supervisory uplift would be quantified and whether it would apply uniformly or be differentiated by product type, such as owner-occupied and buy-to-let portfolios.
- Members highlight that there are certain types of defaults that occur independently of the economic cycle and for which it would therefore be counterintuitive to apply a stress-based scalar to observed default levels. A key example of this is past-term interest-only defaults, where the propensity to default is driven by the maturity profile

[26] Members additionally note that the Bank of England intervened in the early 1990s mortgage market downturn with emergency liquidity assistance to prevent contagion from small banks to larger institutions and to the wider financial system (see Balluck, K., Galiay, A., Ferrara, G., & Hoggarth, G. (2016). *The small bank failures of the early 1990s: Another story of boom and bust*. Bank of England Quarterly Bulletin 56, no. 1).

of the portfolio rather than by the macroeconomic environment. Such areas require careful consideration in the design of any scalar approach.

- If the uplift is implemented as a PD multiplier, it could inadvertently increase measured cyclicality. This potential interaction with other aspects of the framework should be carefully assessed before implementation.
- Overly conservative uplifts could make model monitoring less meaningful by reducing observed variation over time.

103. Aspirants lacking observable data from the GFC also highlight the risk of layering multiple uplifts; for example, one to reach GFC levels and another to extrapolate to early 1990s conditions, which may overstate conservatism and distort calibration logic (notwithstanding the need to account for the uncertainty associated which such a supervisory uplift and to recognise the investments made by firms that have substantial data history). A single, transparent uplift mechanism that can be consistently applied and readily understood is preferred for aspirant firms that do not have GFC data. Some aspirants also suggest that firms should be able to define an economic cycle based on their own portfolio performance for the purposes of the long-run average PD.

104. Some incumbents believe flexibility should be retained for firms with sufficient data to evidence a robust, data-driven internal uplift to address the representativeness issues highlighted in paragraph 102. These are adjustments which firms have not been able to incorporate into their approved/submitted hybrid models due to feedback received during recent PRA reviews. They suggest that such approaches could be permitted under supervisory review, provided that underlying analysis is transparent and well-documented.

105. Some members suggested that the PRA could consider publishing reference default rates or an industry-level data series to support calibration. This could help reduce divergence in firms' assumptions and provide a more objective foundation for backcasting. Others, however, argued that a standardised dataset may still invite conservative interpretation and limit firms' ability to demonstrate the representativeness of their own data.

106. Overall, members support the proposal to use observed performance data from the GFC period (where available) to allow reliance on a realistic and evidence-based foundation for calibration. The proposal is viewed as a pragmatic step that reduces unnecessary complexity and inconsistency arising from firms' approaches to backcasting to the early 1990s to meet current requirements, and a supervisory uplift would provide a common benchmark, reducing interpretative differences across firms and improving comparability of outcomes for like risks.

Q19: Do you have any feedback on how the PRA might design a simplified approach to computing PDs based on limited data with supervisory uplifts?

107. Aspirants agree that a simplified approach for firms with limited data could be beneficial in principle but raise concerns about its practical implementation. They note that many firms not only lack data covering the GFC but also operate portfolios with limited observed changes in default rates. In the absence of sufficient variability in default rates, firms may be unable to reliably measure cyclicality or calibrate grade-level relationships, rendering any uplift mechanism largely theoretical. Where relevant data is unavailable, some large incumbents note that a theoretical calibration may be acceptable, for example using simple additive scaling of log-odds, provided it is subject to supervisory oversight, noting that such approaches have been successfully deployed in cases involving small or data-sparse portfolios.

108. As noted in response to Question 18, applying uplifts at the portfolio level would be more workable than attempting to translate them to grade level, which could introduce additional subjectivity and inconsistency. Aspirants also caution that layering multiple uplifts, such as

one to reach GFC levels and another to approximate early 1990s conditions, could compound conservatism and distort model outcomes.

109. Moreover, aspirants highlight variability in the backcasting methodology, particularly in how firms convert stock default rates from industry data to flow-into-default rates when deriving long-run average PDs, using methods ranging from multiplicative scalars to logical-based formulas. These divergences introduce a lot of variability and uncertainty into the process, which is incompatible with the objective of the exercise (i.e. converting external data from one form to another, usually without any impact or influence from internal data). Different approaches to stock-to-flow conversion can change long-run average PD by c. 10-15% for some firms. If this step remains relevant in any go-forward framework, members suggest the PRA provides a standardised stock-to-flow-conversion approach or an external default flow series to limit variability between firms. Members also welcome guidance from the PRA on requirements linked to the backcasting and assumptions related to changes in possessions and other default triggers through the GFC.

110. Primarily aspirants suggest that the PRA could publish industry-level or reference default data for relevant periods to reduce subjectivity and promote greater consistency in calibration. However, some incumbents caution that even with standardised data, questions around representativeness may persist, leading to conservative interpretations and one-sided adjustments.

111. Some incumbents IRB members express concern that a simplified approach may not resolve existing challenges related to monitoring and validation. Incumbents also suggest that firms with limited data would still struggle to demonstrate meaningful cyclicality or performance stability, and the current cyclicality formula may not produce credible results. Members question how such models could be monitored effectively, undermining the value of ongoing monitoring.

112. Members emphasise that the simplified approach must not result in material divergence across firms. If supervisory uplifts are applied inconsistently, this could undermine comparability and introduce new distortions. A single, transparent uplift, applied consistently at portfolio level and supported by standard reference data, would represent the most practical and proportionate design for firms with limited historical information and for portfolios with limited defaults.

Q20: Do you have any feedback on the challenges that firms may face when monitoring and measuring PD estimates in a stress when using a simplified approach to computing PDs based on limited data?

113. Incumbents and aspirants with submitted AIRB models note that monitoring and measuring PD estimates under stress conditions will be particularly challenging for firms using a simplified approach based on limited data. The absence of long historical series means that many portfolios lack periods of materially elevated default rates, making it difficult to evidence how models behave through the cycle, or to validate the reasonableness of supervisory uplifts.

114. Where a simplified approach results in highly conservative PDs, observed defaults will almost always fall below expectations (potentially even under a stress). This would undermine the effectiveness of traditional monitoring, making it largely theoretical and detached from actual model behaviour. Some aspirants suggest that monitoring for simplified models should focus more on qualitative reasonableness checks and stability assessments rather than strict statistical testing. However, other members highlight the need for monitoring to validate the prudence of the outcomes produced by simplified approaches with known limitations.

115. Incumbents and aspirants with submitted AIRB models highlight that applying the existing cyclicality formula in the context of a simplified approach could produce unstable or

misleading results. For firms without sufficient data to observe meaningful variation in default behaviour across economic conditions, the cyclicality measure becomes highly volatile. Several members therefore suggest that the PRA consider adapting or suspending cyclicality monitoring requirements for firms using simplified approaches, as results under such constraints would lack credibility and comparability. Consideration should also be given to the requirement to not apply the cyclicality cap for stress testing purposes and the implications of that on the final PD outcomes, which may potentially end up being lower.

Q21: Do you have any feedback on whether permitting the greater use of less cyclical risk drivers would be a feasible option that would help firms build compliant modelling approaches?

116. Members generally agree that allowing greater use of less cyclical risk drivers could help stabilise model outputs; however, they note that this flexibility already exists within the current framework. Firms already assess the cyclicality of scorecard variables during model development and balance predictive power with stability to ensure models perform consistently across the cycle. For this reason, members see the proposal more as a clarification than a substantive regulatory change.

117. Members suggest that, in practice, many firms already incorporate less cyclical scorecard variables, such as affordability or income stability measures, and apply optimisation constraints to balance predictive power and overall rating system cyclicality. While using fewer cyclical drivers can reduce cyclicality, it may also weaken model discrimination or limit alignment with other regulatory requirements, such as the requirement to use all available information.

118. Members note that substituting variables alone does not always reduce cyclicality, and non-cyclical scorecards have diminished usability in business processes such as underwriting/origination, pricing, or IFRS 9. Excessive focus on stability could therefore create issues with Use-Test compliance and the need for multiple sets of scorecards, increasing rather than reducing complexity. Incumbents also note that cyclicality is often more effectively managed through calibration choices or the application of MoCs, rather than through significant changes to scorecard variables or model design.

119. Alternatively, some members have proposed an approach to calibration that does not fundamentally seek to reduce cyclicality of the behavioural scorecards. This could be one potential approach that could be discussed with the PRA as part of the simplified PD approach noted in paragraph 128.

Q22: Do you have any feedback on the costs and benefits of introducing periodic calibration of hybrid PD models, whether such an approach would benefit medium-sized firms, and on how the drawbacks the PRA has identified could be addressed?

120. Members generally favour retaining the existing approach whereby hybrid models are not periodically recalibrated, other than in exceptional cases. Members question the benefit of periodic recalibration, given hybrid models are calibrated to long-run averages. Recalibrating to short-term movements, such as quarterly changes, would contradict the long-run intent of the hybrid approach and blur its conceptual purpose.

121. Members note that periodic recalibration would also increase operational, governance, validation and supervisory burdens without materially improving model accuracy or stability. This would also likely increase the cost of model maintenance and may reduce reliance on ongoing monitoring for trigger-based actions if a recalibration is anticipated, as recalibrations could begin to be used for purposes beyond managing cyclicality. Members therefore consider that further analysis and clarity on the mechanics would be needed before this option is taken forward.

122. Incumbents also caution that differing calibration cycles could erode comparability and distort competition.

Q23: Do you have any feedback on whether TtC approaches should be introduced as an alternative to hybrid approaches for medium-sized firms?

123. Some aspirants with EU parent institutions acknowledge that TtC approaches may align more closely with approaches used by EU regulators, offering potential operational benefits for subsidiaries of EU-headquartered groups. These members would welcome greater alignment between the UK and EU residential mortgage IRB frameworks and greater reliance on home supervisor review within the PRA review process.

124. Members note that allowing TtC approaches would not make developing IRB-compliant PD models any easier for non-systemic firms that face data limitations. Firms would still require sufficient data to capture a full economic cycle and challenges such as data scarcity, potential needs for supervisory uplifts, and conservatism would remain. Furthermore, a TtC approach would not simplify model development, calibration or approval processes. Members also note that introducing TtC approaches would necessitate defining how these models interact with hybrid expectations, adding additional complexity rather than simplifying the framework.

125. Incumbents and aspirants with submitted AIRB models do not support introducing TtC approaches as an alternative to hybrid approaches for medium-sized firms. They see this as inconsistent with the objective of achieving comparability across the industry and believe it would introduce unnecessary divergence between firms. The hybrid approach is regarded as the established standard for UK residential mortgage portfolios, and members consider that allowing an alternative methodology would undermine one of the core aims of the new framework: reducing unwarranted variability. There are also concerns that permitting different modelling philosophies for firms of different sizes could distort competition. Portfolios with similar risk characteristics might produce materially different risk weights solely due to differences in model design. Members stress that such outcomes would conflict with the PRA’s objective of enhancing comparability and transparency across firms.

Q24: Do you have any feedback on whether any of the options discussed in this chapter should, if the PRA took them further, apply only to UK residential mortgage exposures or also to residential mortgage exposures in other jurisdictions?

126. Members note that any potential amendment to the cyclicality calibration cap assumption proposed in Topic 1 of the PD chapter would be beneficial for both UK and non-UK residential mortgage portfolios. The underlying rationale and design principles are equally relevant to overseas exposures, as similar modelling challenges exist across jurisdictions.

127. However, the applicability of the simplifications proposed in Topic 2 and Topic 3 may vary by region. For overseas mortgage exposures, PD models are calibrated to local historic stresses to reflect local market characteristics. Accordingly, these proposals are unlikely to be relevant to non-UK mortgage exposures.

Q25: Do you have feedback on whether any other policy changes would be helpful to address any disproportionate barriers faced by medium-sized firms in designing compliant PD approaches for residential mortgage exposures?

128. Members would welcome continued dialogue with the PRA on how a simplified PD approach might operate independently of fixed parameters such as the cyclicality calibration cap or specific stress periods. In due course, members would be open to providing input on stylised examples to help inform future discussions on a simplified PD calibration approach.

129. Non-systemic members further note difficulties in defining ‘comparable portfolios’, particularly when distinguishing between buy-to-let lending with conservative LTV limits and owner-occupied exposures where maximum LTVs may be much higher. Members

suggest that the PRA provides more flexibility to account for differences in risk appetite and lending practices.

130. Both aspirants and incumbents note that evolving market structures, such as the growth of limited company and portfolio landlord buy-to-let lending, have altered how portfolios are modelled and managed. Members suggest that consideration be given to these developments as part of the PRA review process (including on roll-out plans and model approaches) to maintain proportionality and ensure that IRB models remain relevant to current market dynamics.

131. Incumbents identify challenges arising from the PRA's expectation that the cyclicality cap is not applied in the context of stress testing. This may perversely lead to higher cyclicality and potentially lower PDs under stress compared to under benign conditions. Members propose clearer guidance allowing firms to evidence realistic stress behaviour rather than relying on prescriptive uplifts.

132. From a slightly broader perspective, aspirants recommend simplifying the modular application process. Module 1 currently includes requirements better suited to later stages, which delays early engagement with the PRA. Streamlining the initial submission would enable earlier focus on core application elements, while later deliverables could follow in subsequent modules. Members also request clearer guidance on assessment methodology and principles to ensure consistency across submissions.

133. While modelling simplifications considered by DP1/25 may provide an opportunity to reduce barriers to IRB entry for medium-sized firms, attaining a new IRB approval via the modular application process remains a significant barrier for aspirants. An aspirant firm has to gain approval for the wider Phase 2 modules and provide a compelling case in relation to the impacts of Pillar 1 updates as part of the Phase 3 modules (in particular, in Module 6 on stress testing and regulatory reporting). These steps could take significant additional time following model approval, during which the firm would be required to continue to use the Standardised Approach for credit risk capital.

134. Aspirants urge the PRA to revisit the eight-module application process and consider a more proportionate approach that can allow faster approval, particularly where a firm can show its application is suitably conservative. The current application process should be updated to better reflect practices of incumbents to ensure aspirants are not unduly held to a higher bar at the point of application. As part of refining the application process, aspirants urge the PRA to provide explicit guidance on the expectations of each module and pragmatic accreditation roadmaps. This will provide a degree of certainty for firms, PRA supervisory and specialist teams, and wider market stakeholders. To facilitate this, clear PRA stakeholder maps should be available to promote frequent communication.

Q26: Do you have any feedback on how the potential policy changes set out in this DP might impact the PRA's statutory objectives or have regards?

135. Members agree that introducing a FIRB approach for residential mortgages for medium-sized firms would help level the playing field between systemic and non-systemic institutions by allowing eligible medium-sized firms to calculate capital requirements more proportionately, while maintaining prudential integrity. This may enhance competition and encourage more competitive pricing in the residential mortgage market, potentially improving access to mortgage lending for creditworthy borrowers, and complementing broader government objectives around homeownership and economic growth.

136. Simplifying aspects of PD requirements – such as adjusting the cyclicality calibration cap or allowing firms to apply a supervisory uplift to GFC data instead of backcasting to the 1990s – across the market would prevent competitive distortions and reduce modelling barriers without undermining the robustness of risk capture.

137. Some members (across incumbents and aspirants) also highlight that disproportionately high residential mortgage capital requirements risk discouraging investment in UK mortgage lending relative to the EU and other markets. It is noted that achieving greater parity with European frameworks would enhance the competitiveness and attractiveness of the UK banking sector, supporting the broader objective of maintaining a level international playing field post-Brexit. Reducing the complexity of the UK IRB framework (including for incumbents), allowing more firms to achieve IRB accreditation and to use appropriately calibrated risk-sensitive approaches may improve lending capacity, support investment, and enable stronger returns on equity - helping attract capital and foster growth in the UK financial sector.

Q27: Can you provide any insight into the business decisions that firms would take in response to increases or decreases in capital requirements for residential mortgage exposures?

138. Members agree that allowing more firms (and/or portfolios) to obtain IRB status and proportionate reductions in capital requirements would increase lending capacity where mortgage demand remains strong. Alternatively, where demand is stable, more proportionate capital requirements could ease pricing pressures and support more competitive mortgage rates. Reduced capital obligations could also enable firms to allocate increased lending capacity to other sectors with demand, such as SME[27] lending, supporting investment in the real economy and, in turn, economic growth. Members additionally note that more appropriately calibrated capital levels support firms' ability to deliver sustainable returns on equity, enabling them to reinvest in their businesses or distribute excess capital to shareholders or members, supporting retirement incomes and household wealth, rather than holding excess capital inefficiently.

139. Members caution that higher or inflexible capital requirements could constrain lending activity and reduce competition. If simplified and proportionately calibrated approaches to determine residential mortgage capital requirements are not available to all firms, customers could become effectively limited to a smaller group of lenders, creating an uneven market and potentially driving less favourable mortgage pricing and lending availability.

140. Members caution that divergent mortgage risk-weight outcomes between the UK and other jurisdictions could influence portfolio strategies and investment decisions. For example, persistently higher capital requirements in the UK may make other jurisdictions more attractive, potentially diverting lending activity away from the domestic mortgage market and affecting the UK's long-term competitiveness.

Engagement

141. We appreciated the opportunity to discuss some of our views on the discussion paper during the roundtable on 13th October and would be pleased to facilitate any further discussion.

142. UK Finance is content with the PRA publishing this consultation response on its website.

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[27] SME: Small and medium-sized enterprise

List of Abbreviations, Acronyms, and Initialisms

Abbreviation	Description
AIRB	Advanced IRB
AVM	Automated Valuation Model
BCBS	Basel Committee on Banking Supervision
BTL	Buy-to-let
DP	Discussion Paper
EBA	European Banking Authority
ECB	European Central Bank
ESIS	European Standardised Information Sheet
EU	European Union
FCA	Financial Conduct Authority
FIRB	Foundation IRB
FPC	Financial Policy Committee
GFC	Global Financial Crisis
HPI	House Price Index
IFRS 9	International Financial Reporting Standard 9, *Financial Instruments*
IRB	Internal-ratings Based
LGD	Loss Given Default
LTI	Loan to income
LTV	Loan to value
MCOB	Mortgages and Home Finance: Conduct of Business Sourcebook
MMR	Mortgage Market Review
MoC	Margin of Conservatism
MREL	Minimum Requirement for Own Funds and Eligible Liabilities
OO	Owner occupier
PPU	Permanent Partial Use
PD	Probability of Default
PRA	Prudential Regulation Authority
PPGD	Probability of Possession Given Default
RWA	Risk-Weighted Assets
SDDT	Small Domestic Deposit Taker
SME	Small and medium-sized enterprise
TtC	Through-the-cycle