UK FINANCE

A response to the PRA's consultation on

Credit risk: The identification of the nature, severity, and duration of an economic downturn for the purposes of Internal Ratings Based (IRB) models

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Introduction

UK Finance is the collective voice for the banking and finance industry. Representing more than 250 firms, we act to enhance competitiveness, support customers, and facilitate innovation.

We are pleased to respond briefly to the PRA's CP 7/21 on identifying the nature, severity, and duration of an economic downturn for IRB modelling purposes.

Support for the PRA's approach

We support the PRA's approach to the draft UK Technical Standards, which effectively cut and pastes the EBA's the revised amended draft RTS. Our members are already familiar with the requirements set out therein and adopting them into the PRA Rulebook in this way will lead to the most effective and efficient implementation of these requirements. The proposed approach will also have benefits for those of our members that are also supervised by the ECB, for whom the EBA's RTS on this topic will be directly relevant. Minimising divergence between the two regulatory standards will optimise deployment of member resources and ensure modelling approaches are completely aligned.

The nature of economic downturns

We note that paragraph 3.1 (1) of the Draft UK Technical Standards (Economic Downturn Instrument) 2021 identifies four economic indicators that are indicative of an economic downturn. We agree that this and the portfolio specific indicators in 3.1 (2) comprise a comprehensive relevant indicator set.

We note that the draft Technical Standards are silent about whether the absolute level of the indicator or its rate of change is relevant in determining the economic downturn. The best approach may be to require that the most severe form of the economic indicator should be used to identify the downturn period. The draft EBA RTS contains helpful wording in this regard at Recital 11. We have suggested additional wording below to clarify regulatory expectations.

We there for suggest the modification of Paragraph 3.1 of the Technical Standards:

> 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:
>
> …….
>
> 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.
>
> 3.4 *The economic indicators are to be considered in levels or in changes of levels, as appropriate.*

The consultation states (in para 2.7) that "economic factors" should be considered, while the EBA RTS requires that when identifying downturns all relevant economic factors, including macroeconomic and credit related factors, should be considered. We would welcome the PRA;s indication of why it has decided not to specify the types of economic factors to be considered.

Proportionality

We welcome the PRA's confirmation at 3.1 that firms should not incur disproportionate costs in obtaining external data which may be explanatory variables for a particular type of exposure, for instance in a third country, where long run data series may not be available.

We note that the requirement to review specification of an economic downturn at least annually was not included in the PRA consultation. We would welcome the PRA could confirming this is expected to happen or perhaps whether the requirement will be added at a later stage.

Duration and number of downturns

The PRA sets out expectations for duration of downturn in paragraphs 2.11 to 2.14 which is similar to requirements in article 4 of the RTS. However a distinct difference is the draft Technical standard's emphasis on duration of a single downturn. The PRA's Technical Standards do not appear to contemplate that multiple downturn periods should/could be identified. However the recitals to the EBA's RTS clarify that multiple downturn periods may be identified (each to comply with requirements set out for nature, severity and duration which are similar to the PRA's expectation). For instance Article 1 of the RTS requires institutions to "identify an economic downturn that comprises one or several distinct downturn periods […]"

If the PRA does intend that only a single downturn period should be identified, then it follows that the LGD estimated under that downturn condition might need to be adjusted to represent more severe values. This is different from the EBA expectation that requires a firm to identify all downturn periods, (none to be less than 12 months and each to be long enough to cover all the peaks and troughs - which is similar to the PRA expectation for duration of single period) and then for Downturn LGD estimation, calibrate to the one that gives the higher value. We would appreciate the PRA's clarification that this is indeed its intention.

The draft UK technical standard further states that the selected period should result in estimates that are sufficiently severe, where the 20-year historical data does not contain sufficiently severe values for a considered economic factor. In this context, it would be useful if the PRA could provide some more detailed guidance on the expectations for the term "sufficiently severe"and how much more conservatism banks should assign on model parameters in such cases.

Similarly, has 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 (para 2.14). The interpretation of "shortly after", could be subjective, so we would welcome more detailed guidance on the PRA's expectations.

The PRA proposes (in paras 2.11 and 2.12) 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'. 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. In this context, we would welcome further clarification whether the downturn period should be in 'years' (e.g., 1 year, 2 years, 3 years) or can be monthly (e.g., 1 year 3 months, 2 year 5 months). The EBA RTS requires severities of economic indicators to be identified based on the most severe 12-month values, however the single downturn period that covers all such severities is not subject to an annualised requirement (unless all 12-month severities occur at exactly the same time, or at annual intervals).

We note that the consultation paper contains further minor changes to the PRA SS11/13 , in addition to the downturn requirements, are set out in Appendix Two. We are happy to confirm that we are supportive of these changes and the proposed timelines for implementation.

UK Finance and its members look forward to discussing with the PRA this concise response to the CP if appropriate.

Responsible Executive

Simon Hills

✉ simon.hills@ukfinance.org.uk
☎ +44 (0) 7921 498 183