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11th November 2020

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Internal Ratings Based UK mortgage risk weights: Managing deficiencies in model risk capture

The PRA published Consultation Paper CP14/20 on 30th September, proposing the following new expectations in relation to Internal Ratings Based risk weights for UK mortgages:

i. a risk weight of at least 7% for each individual UK residential mortgage exposure; and

ii. an exposure-weighted average risk weight of at least 10% for all UK residential mortgage exposures to which a firm applies the IRB approach.

Background

The PRA identified the following particular **areas of concern** in relation to IRB mortgage risk weights:

- There is **large variation** in IRB risk weights between firms, particularly for low LTV mortgages;
- Average UK IRB mortgage risk weights, are **below international peers**, including at low LTVs;
- Risk weights for low LTV mortgages can be **difficult to calibrate due to limited data**;
- Some IRB mortgage risk weights are **significantly lower than minimum risk weights applied under the standardised approach** (SA).
- IRB mortgage risk weights have been **trending downwards** in recent years and there remains the risk that this will continue on the medium and longer term.

Purpose

The main purpose of the proposals is to **address the prudential risks** stemming from inappropriately low IRB UK mortgage risk weights.

The new measures are **simple, efficient** and specifically **targeted** at addressing the observed areas of concern.

The proposals **complement other regulatory updates** relating to IRB, including the EBA IRB roadmap and the finalisation of Basel III reforms. These further regulatory changes are likely to lead to an increase in some of the lowest IRB risk weights, however they are not specifically targeted at the full range of concerns with UK IRB mortgage risk weights.

The proposals should narrow the differentials between risk weights output by the IRB approach and those output by the SA, and limit future divergence. Hence an **additional benefit** is that they will **support competition** between firms using IRB and those using SA.

Who will be affected?

This CP is relevant to PRA-authorised **UK institutions holding IRB model permissions**. It may be of interest to other firms, including **those considering applying for IRB model permission**, and other market participants.

The PRA does not expect these proposals to result in significant implementation costs, however it has been recognised that the proposals may come with **costs to some firms that use the IRB approach and have particularly low IRB risk weights**. There would be additional capital costs for those firms whose risk weights may increase as a result of these proposals, and where capital requirements are not already determined by other capital measures (e.g. leverage).

The impact will be most pronounced for **firms where mortgages are the predominant asset class.** The PRA have acknowledged that this may mean a greater impact for **mutuals on the IRB approach** than comparative non-mutuals with similar IRB mortgage risk weights but with a more varied asset base.

What next?

The consultation closes on Saturday 30 January 2021.

Following an **assessment of the impact of the proposals** on their mortgage IRB risk weights, affected firms are encouraged to **respond and engage with the PRA** regarding the specific points raised in the CP and other areas that remain unclear.

Furthermore firms should **submit the data template** included in the CP to help inform the PRA's final proposals in relation to the calibration of the metrics.

It is proposed that the final policy resulting from this CP would take effect from Saturday 1 January 2022, alongside other IRB reforms.

Firm should **consider these proposals and the Basel III 'output floor' simultaneously, in their medium to long term plans** to ensure that the structure of their balance sheet is optimized to achieve an appropriate risk-return balance.

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