

PRA confirms model risk principles for banks

AT A GLANCE

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What's new?

- The PRA [published](#) Policy Statement (PS) 6/23 on 17 May 2023, confirming the model risk management (MRM) principles for banks as [proposed](#) in Consultation Paper (CP) 6/22. The PRA has published the final policy through Supervisory Statement (SS) 1/23.
- The PRA has made changes to proposed policy including: amendments to the scope of application, financial reporting, Senior Management Function (SMF) accountability, model tiering/complexity, vendor models, AI/Machine Learning (ML) models and Post Model Adjustments (PMAs).

What does this mean?

- The PRA proposed five principles in CP6/22 that firms should refer to in order to establish an effective MRM framework (the principles have been built on the PRA's existing requirements and supervisory expectations). These principles are intended to support a range of outcomes:
 - proportionate implementation within firms
 - allocation of responsibility to the appropriate SMF holder
 - reporting on MRM effectiveness to the firm's audit committee
 - managing risks associated with the use of AI in modelling techniques.
- The summary of the key changes and the potential implications are as follows:
 - **Scope of application:** The PRA has adjusted the scope of the policy to apply only to firms that use internal models (IM) to calculate their regulatory capital requirements. The PRA states that it will update the approach for other firms once it has finalised the definition of Simpler regime firms under the Strong & Simple regime. Nevertheless, the PRA states that all firms should continue to apply the existing supervisory expectations relevant to them and their particular models, including attestations and self-assessments where applicable.
 - **Financial reporting:** The PRA has clarified that in principle there are no changes made around its expectations related to audit committee involvement. In order to avoid ambiguity, the PRA has replaced the term "accounting" with "financial reporting" and clarified that the intent is to ensure MRM reporting is available to the audit committee.
 - **SMF accountability:** The PRA has clarified that the SMF responsibility for MRM is additional and complementary to the responsibilities of SMF holders for business, risk and control functions. The PRA has also removed ambiguity around the responsibilities of the SMF, clarifying that the SMF is expected to assume overall responsibility for the MRM framework, its implementation, and the execution and maintenance of the framework. The PRA also states that certain duties of an SMF may be delegated and firms have the flexibility to appoint more than one SMF.
 - **Model/tiering complexity:** In relation to its assessment of model tiering, the PRA has confirmed that model complexity should be one of the metrics to be considered. However, the PRA has made the policy less prescriptive on the relevant factors used to determine the model complexity, and

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acknowledged that the factors underlying the model complexity will vary across firms and models.

- **Vendor models:** On documentation provided by vendors, the PRA has acknowledged that this might not be as extensive and detailed as for internally developed models, and that vendors have no obligation to disclose proprietary information. However, the PRA expects firms to ensure the level of detail in the vendor models documentation is sufficient to validate their use of the model.
- **AI/ML models:** The PRA notes that feedback to CP6/22 also covered areas where AI/ML models may present additional risks, including the need for a firm-wide approach given the multi-functional support offered by AI/ML systems, and challenges around model oversight and performance. The PRA states that it will consider feedback to CP6/22 alongside [responses](#) to DP5/22 and the [results](#) of the 2022 ML survey, to inform future policy decisions.
- **PMAs:** The PRA has ensured that PMAs are recognised as appropriate risk management tools and reflected the need for proportionality. The PRA has provided further clarity around the distinction of model adjustments versus PMAs, with the former being identified in advance during the model development process (though this could still depend on the circumstances). Whilst validation of PMAs are a key part of the policy, the PRA has also acknowledged that it would not always be feasible to independently validate adjustments that require the use of significant judgement, or adjustment due to new information becoming available.

- The PRA has introduced other changes around the delegation of board responsibilities; use of group models by subsidiaries; the linkage between dynamic recalibration and model changes; and making the escalation process less prescriptive, while keeping proportionality in consideration.
- The PRA has left other key areas of the draft policy unchanged, despite receiving particular feedback (such as the prescription of the model definition including Deterministic Quantitative Methods).

What do firms need to do?

- With the final SS in place, firms need to identify and appropriately prioritise necessary actions to comply with the PRA's requirements. In particular, firms should note that the PRA will require firms to conduct an annual self-assessment against the MRM framework, and that it also intends to embed its assessment of firms' MRM approach into its wider supervisory assessment. Firms will also need to ensure their governance arrangements support effective oversight of their MRM framework.
- Given that the PRA requires that all model types be subject to MRM procedures, firms should note that this represents a significant supervisory step-change. Firms should also consider their strategic approach to model use in light of wider regulatory changes, such as the PRA's [proposed approach](#) to Basel 3.1 implementation.
- Firms should also consider the MRM policy alongside the PRA's supervisory focus on regulatory reporting and oversight over regulatory models, given the potential requirement for remedial work in this area (in the context of Skilled Person reviews).

Next steps

The policy will be implemented in one year's time (17 May 2024). The PRA has also explained that firms receiving permission to use IMs for the first time after the publication of PS6/23 will have 12 months from the granting of the IM permission to comply with the policy.

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