Financial Services Regulatory Insights

PRA proposes principles to manage model risk

AT A GLANCE

June 2022

What's new?

- The PRA published a consultation paper (CP) on 21 June 2022, setting out its supervisory expectations in relation to firms' management of model risk. The PRA's expectations are formally presented in a draft Supervisory Statement attached to the CP. The PRA is proposing a set of principles to ensure banks establish an effective model risk management (MRM) framework.
- The PRA proposes that its supervisory expectations would apply to all types of internal and external models that firms might use to inform their business decisions, and would apply to banks, building societies and PRA-designated investment firms (but not insurers at this stage). The PRA states that the proposals are intended to complement its existing supervisory requirements and expectations that apply for selected model types.

What does this mean?

- The PRA's stated objective is to support firms' development and implementation of policies and procedures to identify and manage model risk. The PRA's proposals have been driven by observed shortcomings in relation to firms' current practices (such as firms' applications for regulatory model permissions and the board), and the significant increase in firms' use of models in areas such as stress testing and regulatory reporting.
- The PRA is proposing that all firms adopt five principles which would be critical to the establishment of an effective MRM framework. These principles focus on:
  - Model identification and model risk classification - to help firms identify and manage model risk
  - Governance - to support a positive MRM culture throughout the firm
  - Model development, implementation and use - to ensure firms have a thorough development process in place
  - Independent model validation - to provide effective challenge to model development and use
  - Model risk mitigants - to ensure firms establish measures to address model under-performance.
- The PRA sets out how the proposed principles should apply to firms' use of models across several areas:

  Proportionality

  - The PRA states that the proposed principles should be applied in a proportionate manner, depending on a firm's size, business activity, and the extent and complexity of their model use. For example, firms that might qualify as a 'simpler regime firm' would only be expected to apply principle 2 (Governance) to a basic level.

  SMF accountability

  - The PRA expects firms to allocate responsibility for the MRM to the most appropriate SMF holder, which would normally be a senior role holder

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within a firm's overall risk management function. The PRA also expects active involvement of the firm's board and senior management in the firm's MRM governance processes.

Financial reporting

- The PRA proposes that firms should implement regular reporting on the effectiveness of their MRM to their audit committee, to support effective audit planning. The PRA also expects that its proposals will be relevant to firms' use of models for accounting purposes, and considers that the effectiveness of a firm's MRM in relation to financial reporting would form part of its formal audit review.

Use of Artificial Intelligence (AI) and Machine Learning (ML)

- The PRA expects that its proposals would apply to models involving the use of AI technology, such as ML, which from the PRA's perspective might amplify existing model risks. The PRA is seeking specific industry feedback on which aspects of its proposed MRM framework may not sufficiently address risks associated with AI or ML models.

- The PRA is proposing that firms conduct an annual self-assessment against its proposed framework, to help identify any potential shortfalls and appropriate remediation measures. The PRA states that the board should appoint a specific accountable person to ensure remediation plans are in place. The PRA intends to embed its assessment of firms' MRM framework into its BAU supervision of PRA-regulated firms.

What do firms need to do?

- The PRA's proposals represent a major initiative to align its existing supervisory expectations, rules and requirements within the proposed MRM framework. Firms should note that the PRA will now be requiring all model types to be subject to MRM procedures, so its proposals represent a significant step-change. Therefore firms should start to review the range of their model use in relation to the PRA's proposals and consider where they may need to address potential shortfalls.
- Firms will also need to consider the PRA's increasing regulatory focus on the use of AI technology, given the potential implications for firms' investment as part of their core modelling activity. In particular, the PRA announced in its 2022/23 business plan that it will publish a Discussion Paper on AI later in 2022, to explore the PRA's potential role in relation to the challenges and risks related to the use of AI in financial services.
- Firms should also consider their strategic approach to model use in light of the PRA's forthcoming Basel 3.1 consultation, given the potential capital impacts of that reform package. In parallel, firms considering their eligibility for the PRA's proposed simpler firms regime should also review the prospective balance of benefits in relation to their use of models, versus the investment required to support an effective MRM framework.

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Next steps

The consultation closes on 21 October 2022 and the PRA is proposing an implementation date 12 months after the publication of the final SS.