

## PRA Consultation Paper CP6/22

### Model risk management principles for banks

June 2022

<https://www.bankofengland.co.uk/-/media/boe/files/prudential-regulation/consultation-paper/2022/june/model-risk-management-principle-for-banks.pdf>

The proposed requirements are lessened for firms that will qualify as Simpler-regime firms; this digest therefore incorporates the tests for ‘Simpler-regime’ qualification, detailed in CP5/22 *The Strong and Simple Framework: a definition of a Simpler-regime Firm*, April 2022

<https://www.bankofengland.co.uk/prudential-regulation/publication/2022/april/definition-of-a-simpler-regime-firm>

***Governance,  
Risk,  
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- CP6/22
- Overview
  - 1.2 The PRA considers MRM as a risk discipline in its own right...
  - The proposed expectations on MRM are set out in a draft Supervisory Statement (SS) ‘Model risk management principles for banks’ [on which this digest for smaller firms is based]
  - The MRM principles are intended to address specific shortcomings currently observed in UK banks
  - This CP is relevant to all firms in the wider banking sector and their external auditors
  - Consultation closes on Friday 21<sup>st</sup> October 2022 [so we should expect the supervisory statement to be confirmed very early in 2023]: “the PRA proposes that the implementation date would be set at 12 months following the publication of the final SS”]
  - ...which seems like a long way off, but even for small and simple firms there’s quite a bit to be put in place before then: “...by the implementation date of the policy, all firms applying the proposed principles would have undertaken an initial self-assessment against the proposals and, where necessary, prepared remediation plans to address any identified shortcomings”

- “The PRA proposes all firms to adopt five principles which it considers key in establishing an effective model risk management (MRM) framework. The principles are intended to complement existing requirements and supervisory expectations in force on MRM, and include proposals for:
  - a proportionate implementation within firms and across firms, in particular for firms that would qualify as a ‘simpler-regime firm’;
  - the identification and allocation of responsibility for the overall MRM framework to the most appropriate Senior Management Function (SMF) holder;
  - reporting on the effectiveness of MRM for financial reporting to the audit committee; and
  - identifying and managing the risks associated with the use of Artificial Intelligence (AI) technology in modelling techniques such as Machine Learning (ML) to the extent that it applies to the use of models more generally
- The PRA’s proposals are intended to complement, not supersede, existing requirements” [so SS3/18 in particular - *Model Risk Management Principles for Stress-testing* – still pertains]

- The 5 Principles:

- 1 – Model identification and model risk classification**

- Firms have an established definition of a model that sets the scope for MRM, a model inventory, and a risk-based tiering approach to categorise models to help identify and manage model risk.

- 2 – Governance**

- Firms have strong governance oversight with a board that promotes an MRM culture from the top through setting clear model risk appetite. The board approves the MRM policy and appoints an accountable individual to assume the responsibility to implement a sound MRM framework that will ensure effective MRM practices.

- 3 – Model development, implementation and use**

- Firms have a robust model development process with standards for model design and implementation, model selection, and model performance measurement. Testing of data, model construct, assumptions, and model outcomes are performed regularly in order to identify, monitor, record, and remediate model limitations and weaknesses.

- 4 – Independent model validation**

- Firms have a validation process that provides ongoing, independent, and effective challenge to model development and use. The individual or body within a firm responsible for the approval of a model ensures that validation recommendations for remediation or redevelopment are actioned so that models are suitable for their intended purpose.

- 5 – Model risk mitigants**

- Firms have established policies and procedures for the use of model risk mitigants when models are under-performing, and have procedures for the independent review of post-model adjustments

- Proportionality
  - “The rigour, intensity, prioritisation, and frequency of model validation, application of risk controls, independent review, performance monitoring, and re-validation would be expected to be commensurate with the associated model tier assigned to a model
  - Firms that qualify as a ‘simpler-regime firm’ would apply Principle 1 (establish the model definition, keep an inventory and classify models) in full, but would be expected to only focus on the basic elements of Principle 2, Governance”
  - The inference is that simpler-regime firms need to apply Principles 3-5 *only to the extent that they have ‘complex’ models*. ‘Complex’ models are those “that are difficult to understand or explain in non-technical terms, or for which it is difficult to anticipate the model output given the input”

## ■ CP 5/22 - Simpler-regime Firms

- The PRA proposes a maximum size threshold of £15 billion of total assets (averaged over a 36 month window)
- An on-and off-balance sheet trading book business that would be equal to, or less than, both of the following thresholds:
  - 5% of the firm's total assets; and
  - £44 million
- Overall net FX position =/ $<$  2% of the firm's own funds
- No commodity positions
- No IRB approvals
- No provision of clearing, settlement or custody services

- **CP 5/22 - Simpler-regime Firms cont.**
  - At least 85% of a firm's credit exposures must be to obligors located in the UK, where exposures means the exposures reported in COR001a, table C 09.04 *excluding exposures to:*
    - (a) central governments or central banks;
    - (b) regional governments or local authorities;
    - (c) public sector entities;
    - (d) multilateral development banks;
    - (e) international organisations;
    - (f) institutions
  - a firm that...is part of a group based outside of the UK would be able to apply for a waiver or modification to be treated in the same way as a Simpler-regime Firm for the purpose of applying Basel 3.1 and the simpler regime
    - The PRA will consider in each specific case whether the size and activities of the group at a global level are consistent with the firm suffering from the complexity problem. Where this is the case (and subject to the statutory tests being met) the PRA would expect that the firm would likely be able to access the simpler regime through this route



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