



MODEL RISK MANAGEMENT PRINCIPLES FOR BANKS

CP 6/22

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ICAEW welcomes the opportunity to comment on *Consultation Paper 6/22 - Model risk management principles for banks*, published by the Prudential Regulation Authority on 21 June 2022. For questions on this response please contact ICAEW Financial Services Faculty: representations@icaew.com quoting REPRESENTATION 92/22.

Consultation paper 6/22 is relevant to all firms in the wider banking sector and their external auditors¹. Notwithstanding that ICAEW has members that work in banks, we have restricted our response to the implications of the proposals for a bank's auditor. Moreover, we have restricted our comments to high level themes, rather than consider the detailed draft proposals.

ICAEW supports the Prudential Regulation Authority's (PRA) development of model risk management (MRM) principles for banks, and the application of those proposals to models used for financial reporting purposes. ICAEW also supports the PRA's stated aim of enhancing audit quality and we agree that a framework for model risk management would be a positive and beneficial step to this end.

Our overall main messages and themes are:

- We believe that the proposals will enhance the quality of bank audits. The proposals will strengthen the control framework around the use of models that are likely relevant to the auditor's work. In this respect the auditor should be able to obtain a better understanding of the risks and controls around the use of models and may be able to place more reliance on those models. The proposals should help give more focus to the need for good controls over the use of accounting models, which have perhaps traditionally had less focus than prudential models.

The proposals should also help establish a common framework for trilateral discussions between the auditor, the firm and the regulator.

- We do not believe the proposals are intended to increase the level of audit work. We believe the role of the auditor expressed in the supervisory statement is clear and should not increase the level of audit work. There seems however a risk that the overall consultation might potentially create expectations of auditors that go beyond the requirements of auditing standards, and potentially lead to additional work and higher costs for firms. We suggest the PRA clarify the requirements of auditing standards in any

¹ Paragraph 1.3 of the consultation paper

further internal guidance that it produces, to ensure there are no unreasonable expectations on auditors.

- Elements of the proposals build upon other aspects of the prudential regime (eg, the simpler-regime). This seems appropriate to ensure the overall prudential regime is coherent. In principle we think that extending the draft proposals to non-prudential models can work. We would note however that there can be differences between the use of models for prudential and non-prudential purposes, and we think the supervisory statement may benefit from further explanation or clarification to explain how the proposals apply to non-prudential models (eg, proportionality, application to groups as explained in more detail below). The PRA should also reflect whether there are other areas that may warrant further consideration.
- We agree with the principles-based approach set out in the supervisory statement. Principles facilitate a flexible approach that can accommodate the range of firms and practices that may exist, and that can adapt to changes over time. There is a risk however with a principles-based approach that there is a lack of precision or clarity, leading to inconsistent implementation and / or a failure to sufficiently meet regulatory expectations. A general theme of our comments is that more guidance may be required in some areas.

Our detailed observations in support of these comments can be found below.

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Detailed observations

In scope models (paragraph 1.5 to 1.9 of the supervisory statement)

1. We find the definition of in scope models, as expressed by paragraphs 1.5 and 1.8, to be potentially very broad (eg, any excel spreadsheet that contains a formula used by the general business). We see the benefit of a strong control framework as envisaged by the MRM framework applying to a bank's models. However, we can also see that firms may require further help to determine whether certain models are within the PRA's intended scope and / or how to apply proportionality to ensure the potential burden from implementing the framework does not become onerous. For example, in paragraph 1.5, what does the term 'general' in the phrase 'general business and operational activities' mean? Or in paragraph 2.8 of the consultation paper, models based around AI or ML might be expected (at least now) to be complex models; but what other types might be complex?
2. In general, the draft supervisory statement lacks an application paragraph that gives a clear expression of the models in scope. It would be helpful if the introductory paragraphs of the draft supervisory statement could clarify the models in scope of the proposals. In this regard it would also be helpful to clarify the approach to models used for non-financial reporting and whether at this stage certain models are clearly out of scope.

Application to multi sector groups

3. Paragraph 1.2 of the draft supervisory statement indicates that the proposals are relevant to UK incorporated banks, building societies and PRA designated investment firms. It is not stated but it is presumed that the proposals are intended to be applied across a firm's group (because for example not all significant lending activities will reside in the legal banking entity). Paragraph 1.3 of the consultation paper indicates that the proposals do not apply to insurance firms. In this regard it is unclear how banking groups with insurance business may be affected. This is particularly relevant when considering that the banking consolidation group for prudential purposes is different to the financial reporting consolidation group where insurance business is clearly part of the balance sheet consolidation and is covered by the group audit opinion. The PRA should clarify how it intends the proposals apply across a group and how insurance business be treated. It should also be aware that a single approach may not work for prudential and financial reporting models. From an audit perspective, it would be helpful for insurance accounting models to be in scope of a model risk management framework.

Proportionality (paragraph 1.14 and 2.8 to 2.11 of the consultation paper, and paragraphs 1.22 to 1.25 of the supervisory statement)

4. We would support the application of proportionality and materiality to the proposals to ensure they are not unduly burdensome. The proposals apply proportionality largely by reference to qualitative terms (eg, material). However, proportionality is also applied by reference to the simpler-regime, a prudential rather than accounting concept. Paragraph 1.25 of the supervisory statement indicates that material models for simpler-regime firms should be subject to principles 3, 4 and 5 but only at the highest level. Paragraph 1.25 also indicates that a simpler-regime firm will have a limited number or no such models. From a prudential perspective this may be appropriate, but it may not always be appropriate from an accounting perspective – in particular, if a simpler-regime firm has IFRS 9 models they will likely be material and it may be beneficial to the auditor for the full framework or more elements of the framework to apply.
5. We would suggest that the PRA review the respective requirements of the prudential and accounting regimes when setting its approach to proportionality and / or further clarify that the materiality of models may differ between prudential and accounting regimes, and that the firm should think how the different regimes apply to determine its approach.

Expectations of the auditor (paragraphs 2.15 to 2.17 of the consultation paper and paragraphs 1.28 to 1.29 of the supervisory statement)

6. We agree with the statement in paragraph 2.17 of the consultation paper that the effectiveness of the MRM2 for financial reporting is relevant to the auditor's role. Models are typically and increasingly an important part of a firm's approach to preparing its financial statements, and a stronger control environment as envisaged by these proposals should be a benefit when undertaking an audit.
7. The final sentence of paragraph 2.17 however seems to assume that the auditor will engage with the effectiveness of the MRM. We think this potentially creates supervisory expectations that go beyond the requirements of auditing standards. The concerns include that expectations are being created that the auditor will always engage comprehensively with the MRM, and that the auditor will consider the effectiveness of the MRM framework. While both are possible, we don't think either are certain. The auditor will engage with the MRM framework to the extent it is relevant to the audit of the financial statements. It is the auditor's professional judgement as to the risk assessment procedures to undertake and following their risk assessment what further work to undertake to be able to give their audit opinion. As a result, the auditor may not engage with all aspects of the MRM framework nor at the level of detail set out by the proposed principles. Moreover, the auditor will not formally form a view on the effectiveness of the MRM framework.
8. We are unclear how the consultation narrative will be used going forward – but if it forms part of the supervisory approach, we suggest there needs to be further guidance to clarify the precise obligations of the auditor towards the MRM framework in the context of a financial statements audit – ie, that the nature of the auditor's work may not result in a comprehensive consideration of the effectiveness of the MRM framework.

Internal Audit (principle 2.5)

9. Most of the detailed narrative of the principle is testing the design of the MRM, though paragraph b iv) does partially cover the operating effectiveness of the MRM. We would suggest the principle is amended (paragraph a) to clarify that Internal Audit should assess both the effectiveness or appropriateness of the design of the MRM framework and separately assess the operating effectiveness of the MRM – ie, given the design of the framework that it is operating as intended. Paragraph b iv) covers operating effectiveness in part but does not for example cover whether the governance is working in practice.

Artificial Intelligence and Machine Learning (AI/ML)

10. We believe that the principles, being general in nature, should cover most of the relevant AI/ML risks. We note that the consultation paper sets out some risks unique to the use of AI/ML models. There are however other risks, such as unintended actions, bias, unfairness, lack of transparency. Given the potential growth in AI/ML models, we would suggest consideration is given to whether more specific guidance is needed to deal with such models. For example, an explicit requirement to consider the ethical implications of the use of AI/ML (eg, financial inclusion arising from the potential for unbanking, discriminatory pricing or service quality), and the extent to which it might carry regulatory risks in respect of the firms conduct and their treatment of customers might be included within Principle 2 (governance).