

Reducing variation in credit risk-weighted assets – constraints on the use of internal model approaches



Introduction

1. The BPF represents the UK's commercial real estate (CRE) sector – an industry with a market value of £1,662bn which contributed more than £94bn to the economy in 2014. We promote the interests of those with a stake in the UK built environment, and our membership comprises a broad range of owners, managers and developers of real estate as well as those who support them. Their investments help drive the UK's economic success, provide essential infrastructure, and create great places where people can live, work and relax.
2. Our comments below are mostly in connection with the proposal to remove the IRB approaches for specialised lending exposures, in particular to income producing real estate (IPRE), leaving only the Standardised Approach (SA) and the IRB supervisory slotting approach.

Key points

The wider context

3. Since the financial crisis – which exposed enormous vulnerabilities in banks' capital structures – the rules on bank capital requirements have changed considerably, as have banks' capitalisation levels. Much has been achieved in making the system stronger and more resilient, in improving risk management and in embedding risk-consciousness in key decision-making.
4. However, we are concerned about the potential cumulative impact of these changes on banks' ability to support the real economy. Given that banks remain the main source of debt finance for CRE businesses in most of the world, we would urge the BCBS to carefully consider any further changes it makes to the rules in light of the impact they might have on investment in the built environment, economic growth and productivity gains.
5. We are also concerned about the apparent lack of thought given to the interaction between a revised SA to CRE lending, with three risk categories, ranging from 80% to 130%, and a supervisory slotting framework with four (non-default) risk categories ranging from 70% to 250%. It is hard to understand why the ranges are so different and concerning that the sole criterion used to determine risk weighting under the standardised approach is loan to (implicitly, market) value (LTV) ratios. It is also concerning that the lowest risk weights for CRE are so high given that CRE lending can (and should) be conducted on a very low risk basis in many cases.
6. We recommend that the BCBS gives further thought to the treatment of CRE lending under the SA and supervisory slotting (and the coherence between two approaches) and would be delighted to provide further input in this area.

Views on supervisory slotting

7. The UK financial regulator implemented mandatory supervisory slotting for the UK income-producing real estate exposures of the banks it supervises around five years ago. UK lending institutions have generally adjusted their systems and methodologies to its requirements, suggesting that from a purely operational

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perspective the transition from an IRB approach to supervisory slotting can be carried out in a relatively short space of time.

8. However, of far more concern is the limited number of risk weight categories under slotting, which gives rise in many cases to a **significant mismatch between true economic risk and regulatory capital** outcomes. CRE assets vary enormously in their characteristics; each CRE transaction is practically unique, with its own set of risks. It is true that this makes modelling CRE risk difficult – but any system for determining regulatory capital requirements on such assets should be capable of taking this variety into account.. Unfortunately, slotting – with only four categories for non-defaulted loans – fails to do this.
9. As a result, slotting is both overly conservative (at the safe end of the CRE lending spectrum) and not conservative enough (at the riskier end of that spectrum). Undesirable cliff edges also arise around the borders of each slotting category and incentives exist to lend at the riskier end of each category to maximise returns within that particular category. Slotting also discourages lenders from developing deep and lasting relationships with their borrowers, as it removes regulatory capital advantages that may be gained through a better understanding of a borrower's business.
10. Accordingly, our view is that slotting distorts the CRE lending market in undesirable ways with an impact that is felt in the real economy, as the projects that banks are incentivised to lend against are not necessarily those that make the most economic sense.
11. We understand the BCBS's desire to reduce RWA variance across lenders and concerns regarding the difficulty in accurately modelling risks where data is limited. However, it is hard to see how the proposals in the consultative document, which involve the imposition of a less accurate, less sensitive and more distortive regulatory model of CRE lending, will be of much benefit to anyone.

The future of IRB approaches

12. Despite their imperfections, we believe that internal models remain the best option for estimating banks' true risks across their portfolios. Of course, these models should be rigorously scrutinised and constantly updated and improved as better data and modelling techniques emerge. However, our view is that in the context of idiosyncratic lending exposures such as CRE, a model-based approach will ultimately most closely align capital with risk, particularly if regulators encourage better data collection across such asset classes.
13. We would like to see banks continue to develop their understanding of lending risk and we consider that the best way to achieve this is for them to relentlessly refine their internal models. Sadly, the proposals in the consultative document will remove a significant incentive for banks to do so as their capital requirements will now be determined in a way that effectively removes their responsibility to properly understand risk. Those lenders that have spent significant resources in developing, gaining regulatory approval for, and maintaining internal models for IPRE exposures may be justified in feeling it was all just a waste of time.
14. As noted above, we understand the BCBS's desire to reduce RWA variance across lenders and we suspect that the consultation proposals would achieve that outcome in a relatively short space of time. However, surely the right approach to take over the medium to longer term would be to incentivise lenders to continue to develop their understanding of risk.
15. For specialised lending exposures (SLEs) in particular, the framework is already in place to allow supervisors to insist on high standards before accepting that data and model quality justify approval. Rather than alter

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that framework, the BCBS should concentrate on encouraging greater consistency in the way regulatory authorities in different countries use it.

16. With that in mind, to the extent that the BCBS goes ahead with the consultative document proposals, we would encourage it to consider the use of a 'sunset provision', such that after a period of, time there is a mandatory reconsideration of whether IRB approaches have become acceptable.
17. That time should be well spent by banks and regulators in working towards greater consistency among banks in the modelling assumptions and parameters they adopt, such as is already taking place under the aegis of the Institute of International Finance (IIF). Regulators should also strive for greater consistency in the criteria they use in determining whether to approve a model for SLEs.

We remain at your disposal should you wish to discuss any of the above in more detail.

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