

Cambridge & Counties Bank (C&CB)

Response to the Basel Committee on Banking Supervision (BCBS)
Consultation on the Standardised Approach to Credit Risk

January 2016

Introduction & Context

Cambridge & Counties Bank is a growing UK bank providing niche services to UK SMEs. We specialise in delivering responsible business lending, in the form of commercial loans, business mortgages and Asset Finance products, while providing a secure, convenient home for the deposits of businesses through our business savings account.

We have limited our comments to the parts of the consultation that directly affect us, i.e. the proposals regarding corporate exposures and exposures secured by real estate. All of our commentary is from a UK specific perspective.

In terms of the BCBS' follow-up work, we are keen to be included in the planned Quantitative Impact Studies and will be engaging via the British Bankers Association and the Prudential Regulatory Authority.

General Commentary

We are broadly supportive of the BCBS's proposals, bringing as they do a greater degree of risk sensitivity to the standardised approach. We would hope that, together with other initiatives currently in progress, these proposals will help to address the significant competitive advantage currently enjoyed by banks using the IRB approach. In our opinion, these proposals do not go far enough to redress the current imbalance between capital requirements for Standardised and IRB firms and the final set of recommendations should do more to level the playing field between standardised and IRB banks.

We have a number of concerns about the differentials in risk weights between certain asset classes in both the current standardised approach and under the proposed changes. For example, the current risk weights applicable to retail exposures mean that unsecured personal debt carries a risk weight of half that applicable to a commercial loan secured on land for development. We would suggest that BCBS revisit the absolute and relative risk weights to ensure appropriate risk sensitivity between asset classes.

We do not believe the proposals sufficiently differentiate between higher and lower risk assets within exposure classes. Using residential buy to let property as an example, the proposed risk weights range from 70% to 120%. Accepting that LTV is highly correlated with loss given default rates in this sector, we suggest that the BCBS considers widening the range of risk weights to increase the risk sensitivity of the revised Standardised Approach.

Finally, although we consider the BCBS objective of driving consistent banking standards, we believe that the nuances of local markets mean it is appropriate to retain a significant degree of national discretion in the framework to allow national competent authorities to reflect the specific risks of their local economies.

Specific Commentary – Main Consultation Paper

a) Risk Weights for Exposures to Banks (Section 1.1.1)

For smaller banks such as CCB, exposures to banks have a very low materiality (essentially representing working capital held with clearing banks). We are concerned that the due diligence requirements applicable to use of credit ratings in calculating risk weights for these exposures would prove to be a significant operational overhead. We are also concerned about whether smaller banks possess the operational capability to perform meaningful due diligence on the external rating. We would suggest that the BCBS considers a materiality threshold for this requirement.

b) Risk Weights for Exposures to Corporate SMEs (Section 1.1.2)

We welcome the proposed reduction in the risk weight for Corporate Exposures to SMEs from 100% to 85% and agree with the rationale provided that this is in recognition of their unrecognised physical collateral and low asset value correlation. We do; however, question the differential in risk weight between SMEs in the Corporate exposure class and SMEs in the Retail Exposure class. We would suggest that; unless the BCBS has convincing data to suggest otherwise, a uniform risk weight for SMEs would be more appropriate.

c) Risk Weights for Specialised Lending Exposures to Corporates (Section 1.2)

We accept that specialised lending is inherently more risky than mainstream lending and welcome the greater clarity in the definition of the Land Acquisition, Development and Construction (ADC) sector. We do question however whether there is scope to incorporate greater granularity of risk within the asset class; for example:

- To differentiate between commercial and residential asset classes. In the UK there is a clear differentiation in the underlying risk between the asset classes (this may not be the case in other jurisdictions, hence the need for national discretion for Competent Authorities), given the consistently high demand for residential property.
- To differentiate between financially weak borrowers and those with the capacity to absorb difficulties in selling the property.

Additionally, we are concerned with the current wording of the definition of ADC. As written, we believe that the definition could be interpreted as including all interest only loans (which are typically repaid by selling the property). We do not believe that this is the BCBS' intention.

d) Risk weights for Real Estate Exposure Class (Section 1.5)

We are broadly supportive of the proposed taxonomy and the introduction of the specialised lending subcategories. We do not; however, entirely accept the logic that loans where repayment is materially dependent upon the cash flows generated by the property are inherently higher risk than those where there is no dependence.

- We accept that both residential and commercial owner occupiers might have a greater personal commitment to avoiding defaults on a loan securing their home or business premises than a professional landlord might have on an investment property. However, the trigger of both rent arrears by tenants and loan arrears by owner occupiers is typically unemployment or underperformance of the owner occupier business. In this, or with any other rent arrears, landlords act as a loss absorbing buffer between rental arrears and loan defaults by absorbing short term rental arrears from their own resources and by replacing tenants with longer term rental arrears. While demand for residential and commercial property outstrips supply, as it is

forecast to do in the UK for the foreseeable future, this ability to replace non-performing tenants remains a significant risk mitigant.

- One of the current concerns about the UK investment property sector is the ability of the borrower to continue servicing the loan in the event of interest rate increases. In the residential sector, most tenancies are on an Assured Shorthold Tenancy (AST) basis. These are typically six month contracts and give landlords the ability to react to interest rate rises at the end of the contract (i.e. within six months in all cases). This contrasts to the ability of owner occupiers to increase their incomes to keep up with increasing loan repayments; typically employed income will only increase annually at best. We accept that the situation in the commercial property sector is more nuanced, with a greater variety of rental terms and less ability to increase rent outside of pre-set rent review points; however, the ability of landlords to replace tenants unwilling or unable to meet increased rental payments continues to act as a significant mitigant to default risk in the commercial property sector as it is easier for a landlord to replace a non-performing tenant than it is for an underperforming business to turn itself around.
- In our experience it is relatively unusual for investment property loan arrears to occur without there being prior rental arrears. In situations where this occurs (for example, where landlords are diverting rents for other purposes) banks have the option of stepping in to collect rents directly from tenants; therefore we do not believe that this materially increases the risk associated with investment property versus owner occupied property.
- One of the rationales provided for applying a higher risk weight to investment property than to owner occupied property is the higher correlation between default rates and security values. We accept this point; however, believe it would be better mitigated by basing the LTV ratio on the lower of market value & vacant possession value than by the proposed split of risk weights between the asset sub-classes.
- A further cause of default on owner occupier residential exposures is the build-up of unsustainable levels of other debt, secured with further charges over the property. With investment property exposures, the facility terms will frequently prevent additional charges being taken, meaning that in the event of default, repossession and liquidation of the asset can proceed more smoothly.
- While there are potential issues developing in the UK investment property sector, we do not believe that these exposures are inherently more risky than other residential mortgages and that it is the culmination of other risk drivers (for example high LTVs, over leveraged landlords, interest only terms and lack of capacity to absorb interest rate rises.) that are the real drivers of these concerns. We would suggest that risk weights are better focussed on these drivers of risk than on an artificial distinction between investment property exposures and owner occupier exposures.

One area that we are not clear on is whether the proposed changes to risk weights are intended to complement or to supersede the current SME factor set out under [Article 501 of the Capital Requirements Regulation](#). We understand that this is an overlay introduced by the European Banking Authority, but are not clear whether the current proposals are intended to remove the need for the overlay or whether it is likely to remain. We would welcome clarification on this point.

a) Risk Weights for Defaulted Exposures (Section 1.8)

While we accept that defaulted exposures should attract a higher risk weight, we question whether all exposures in default should be treated equally or whether there is scope for a treatment that reflects the differing LGDs of defaulted deals with high quality security in

place as opposed to other exposures. For the property asset classes an LTV scale (as proposed for non-defaulted exposures) might be appropriate.

Specific Commentary – Annex 1

b) Exposures to Corporate SMEs (Section 6, paragraphs 34 & 37)

See comments under [Exposures to Corporate \(Section 6, paragraphs 34 & 37\)](#) above.

c) Retail Exposures (Section 8, paragraphs 46)

Further to the comments under [General Commentary](#), we are concerned that the risk weight differential between asset classes does not reflect the actual risk of the underlying assets. While we accept that portfolio diversification implicit in the granularity criterion of the “regulatory retail” definition provides a benefit, we continue to find it non-intuitive that even a well-diversified portfolio of sub-prime credit cards or overdrafts attracts a lower risk weighting than other exposures with high quality security in place. We request that the BCBS reviews the underlying data to ensure that the current and proposed differentials in risk weight between asset classes remain appropriate.

Additionally, we are concerned that the granularity and low value criteria may penalise smaller banks, particularly in the private banking sector.

d) Real Estate Exposures (Section 9, paragraph 50)

We are unclear from the wording of the proposals how the requirement that property be completed would apply to property undergoing refurbishment or conversion. Our expectation is that the restriction would apply only to property in the process of construction and property being refurbished would meet the criterion; however, we would welcome further clarification on this point from the BCBS.

e) Real Estate Exposures (Section 9, paragraph 52)

The BCBS proposes that the LTV is based on the value of the property at origination, unless national supervisors elect to require banks to revise the value downwards. While this approach will reduce pro-cyclicality in capital requirements, it reduces the risk sensitivity. We would suggest that pro-cyclicality be managed through other mechanisms and that LTV should be calculated on the current value of the property, particularly given the Capital Requirements Regulation’s requirements for regular revaluation¹.

We also refer the BCBS to our previous suggestions under [Real Estate Exposure Class \(Section 1.5\)](#) about the potential use of vacant possession value for rental properties.

f) Real Estate Exposures (Section 9, paragraphs 54-60)

We refer the BCBS to our previous comments under [General Commentary](#) about the lack of differentiation between high and low risk exposures within asset classes. We would suggest that the BCBS increases the range of risk weights between LTV bands and also increases the number of bands. This will reduce the “cliff edge” effects of the current broad bands and improve risk sensitivity.

We also refer the BCBS to our previous comments under [Real Estate Exposure Class \(Section 1.5\)](#) about the differential in risk weights for investment property and owner occupied property which we do not believe are justified.

¹ [Article 208](#)