



Secretariat of the Basel Committee on
Banking Supervision
Bank for International Settlements
Ch-4002 Basel
Switzerland

11 March 2016

Clydesdale Bank
40 St. Vincent Place
Glasgow
G1 2HL

Ian S Smith
Chief Financial Officer

Dear Sir/Madam

Revisions to the Standardised Approach for Credit Risk – second consultative document

Clydesdale Bank PLC (CB PLC) welcomes the opportunity to respond to the Basel Committee on Banking Supervision's (BCBS) second consultation paper 'Revisions to the Standardised Approach for Credit Risk' and share with you our views.

CB PLC is an established and ambitious bank with over 2.8 million retail and business customers in the United Kingdom (UK). We put customers and our local communities at the heart of our business and aim to deliver choice and a high quality, personal service. CB PLC, which also operates under the Yorkshire Bank trading name, offers a range of banking services for both personal and business customers through its combined network of 275 retail branches and 40 Business & Private Banking centres, as well as its direct banking and broker channels.

Prior to responding in more detail on specific areas of the consultation paper we set out our key high level points below.

Basel Developments

As a contributor to the first Basel 'Revisions to the Standardised Approach to Credit Risk' consultation issued in December 2014 we welcome a number of the amendments made to address the issues raised. This includes the removal of the debt service coverage ratio as a risk factor from the residential mortgage risk weighting calculation, the reinstatement of the use of external ratings and the recognition of a lower risk weight for SMEs in comparison to unrated corporates.

We remain supportive of the Basel Committee objectives to increase risk sensitivity and ensure the Standardised Approach (SA) remains a suitable alternative to the Internal Ratings-Based (IRB) approach.

Calibrations

We note that it is not an intended outcome of the proposals to increase capital requirements in aggregate across the industry. However we still have concerns on how the risk weights have been calibrated within certain asset exposure classes. The risk weights proposed for exposures secured on residential mortgages remain significantly higher than the average internally modelled risk weight and, as a result, the gap between the SA and IRB approach remains too wide. This perpetuates a significant and unjustified competitive disadvantage for SA banks.

The proposed risk weights for exposures to residential real estate where repayment is materially dependent on cash flows generated by the property would adversely impact buy to let (BTL) financing. In our view the

risk weights are too high and do not reflect the risk incurred nor the differences in underwriting criteria applied by individual firms. We do not view BTL lending in the UK to be significantly more risky than financing of owner occupied residential real estate. In this context we would welcome further clarity on the definition of "materially dependent", particularly given our underwriting and credit decisions consider a broad range of factors in addition to rental income.

We also have concerns on the calibrations proposed for off balance sheet exposures and the removal of the relationship between the credit conversion factor (CCF) applied and the length of the commitment. This substantially increases the capital held for essential working capital facilities for corporate customers and does not accurately reflect the risk; given the often very short term nature of these payment facilities (i.e BACS payment services in the UK).

Linkage with IRB

It remains of critical importance for banks on the SA to credit risk that there is a seamless, co-ordinated, well aligned approach with the wider piece of work being undertaken by BCBS on the IRB capital floors to ensure SA banks do not become uncompetitive.

As the largest bank using the SA in the UK, with credit risk measured on the SA across all our portfolios, we remain an interested party in how the revisions to the SA and results of the Quantitative Impact Survey (QIS) will influence the internal model based approach as regards both capital floors and reduction of the so-called 'full use' requirement.

Comments on Specific Asset Classes

Claims Secured by Real Estate

LTV provides a good indicator of probability and loss given default and therefore we welcome the removal of the debt service coverage (DSC) ratio as a secondary risk driver for this exposure class. We agree with the proposal that the DSC should instead be a key underwriting criterion in the assessment of the borrower's ability to pay.

Proposals on a general treatment for exposures secured by real estate where repayment is not materially dependent on rent/ sale of the property

Loan To Value

We note the further granularity of the LTV risk weightings proposed in Table 9 with the objective of providing a more risk sensitive approach. Although further granularity is welcome our opinion is that this does not go far enough and the risk weights remain significantly higher than the average risk weights applied under the IRB approach, especially for exposures with lower LTVs. The security held should be appropriately recognised through a lower risk weight and the gap between the IRB and SA significantly narrowed. On receipt of the data collated under the secondary QIS we would ask the Committee to consider increased granularity through additional LTV break points at the lower LTV range and the reduction of risk weights across all LTV buckets.

Property Valuation

Concerns remain on using a static valuation taken at origination in the calculation of LTV and we would ask the Committee to permit the use of updated market values whether that resulted in an increase or decrease in value. A LTV measure based solely on valuation at origination fails to consider changes in property prices and does not reflect the real variation in risk over the life of the loan.

An approach based solely on LTV metrics taken at origination is also likely to lead to unfavourable consequences in the mortgage market by providing an incentive for re-mortgaging and churning of loans as house prices rise. There will be an impact on first time buyers as high LTV loans will inevitably be restricted. This is a customer segment that already struggles to enter the housing market in the UK. The impact would be compounded for interest only mortgages where there is no amortisation to apply. We would therefore ask the Committee to permit the use of updated property indexation in measuring LTV which more accurately reflect the credit risk.

Proposals on a more conservative treatment for exposures secured by real estate where repayment is materially dependent on cash flows generated by the property

Buy to Let

We have interpreted that the proposed higher risk weights in the consultation paper capture BTL financing when repayment is materially dependent on cash flows generated by the property e.g. rental income. The Committee's proposals in relation to financing of BTL housing will substantially increase the capital requirement and is an overly penal treatment in comparison to the risk. A well-managed BTL lending portfolio has a similar risk profile to that of an owner occupied residential mortgage portfolio yet the differential in risk weights proposed is significant. CB PLC focuses on providing BTL financing to medium net worth clients (not professional landlords) with an underwriting approach that is based on total customer affordability not simply rental income. Our current asset quality experience in BTL mortgages is better than owner occupied mortgages with a 90 day past due percentage of 0.48% compared to 0.8%, and over the last 3 to 4 years has basically been comparable.

National Discretion

The Capital Requirements Regulations (CRR) currently differentiates exposures to real estate where repayment is materially dependent on cash flows generated by the property, however article 125 of the CRR allows for national discretion to be applied where the competent authority of that Member State has published evidence demonstrating a well-developed and long-established residential property market is present.

In the UK the PRA published such evidence in its Supervisory Statement 10/13 in December 2013, deeming low write off rates in this market to justify risk weighting exposures on the same basis as exposures where the repayment is not materially dependent on cash flows generated by the property.

As the Capital Requirements Regulations (CRR) currently allow we suggest that where competent authorities have evidence of a well-developed and long established property market, supported by published low loss rates in their territory, BTL exposures should continue to be treated on the same basis as the secured by real estate exposure category.

Definition of "Materially Dependent"

We request that the Committee publishes guidance on the definition of "materially dependent". In the context of BTL CB PLC's decision to lend criteria comprise more than rental income - we consider the borrowers' total affordability including other income, expenses and a proportion of rental income. In addition a stress test is applied as part of the credit assessment. Underwriting approaches and criteria differ across the market and where a customer can afford repayments with no recourse to rental income we view this as not being "materially dependent". Without clarity there is scope for inconsistency in application across jurisdictions. We would also advise the Committee that firms may be applying different assumptions to interpretation as part of completion of the QIS.

Interest Only Mortgages

We would also question whether it is the intention of the Committee to bring into scope interest only mortgages in this category where repayment is dependent on the sale of the property. Sale of the property is a legitimate form of repayment for some customers where the stated intention is down-sizing. Adding further restrictions to interest only mortgages would be considered to be acting against the interests of customers, primarily customers borrowing into retirement and we do not feel these customers should be disadvantaged.

Housing Associations

We would request the Committee further clarifies the exclusion in footnote 50 to paragraph 56, to ensure Housing Associations in the UK are captured within the exclusion from the approach for repayment materially dependent upon cash flows generated from the property. We have contributed to alternative

footnote wording proposed by the UK's Council of Mortgage Lenders (CML) in its response to the consultation.

Exposures to Corporates (SMEs)

We welcome the recognition that exposures to SMEs should receive a lower risk weight. However we note that it is proposed that the 75% risk weighting only applies to SME lending that is managed on a portfolio basis and relationship managed SME loans attract a higher risk weight of 85%. We see no fundamental difference between these two SME sub-classes and recommend all SME lending be risk weighted at 75%.

Off Balance Sheet

The proposals to increase the CCF from 20% to between 50% and 75% for undrawn balances will create a substantial capital requirement in respect of essential payment facilities for corporate customers (i.e. BACS payment services in the UK), including SMEs, which does not accurately reflect the risk given the often very short term nature of these facilities.

We do not support the removal of differentiation between CCFs for commitments less than or greater than one year which we believe provides recognition of the risk differential between long and short term commitments. If the Committee considers that one year is too long, then we would prefer to see some form of maturity split, (e.g. 3 months) that would still allow a differentiated approach for very short term facilities.

We appreciate this opportunity to provide our comments on the consultation and would be pleased to discuss our comments further if this would be helpful.

Yours faithfully,

A handwritten signature in black ink, appearing to read 'I. Smith', with a long horizontal flourish extending to the right.

Ian Smith
Chief Financial Officer