

Capital Floors: The Design of a Framework based on Standardised Approaches

Response by the Council of Mortgage Lenders to the Basel Committee on Banking Standards Consultative Document

Introduction

1. The CML is the representative trade body for the residential mortgage lender industry that includes banks, building societies and specialist lenders. Our 125 members currently hold around 95% of the assets of the UK mortgage market. In addition to lending for home-ownership, the CML members also lend to support the social housing and private rental markets.
2. We are grateful for the opportunity to respond to the Basel Committee on Banking Standards (Basel), consultative document on capital floors and the design of a framework based on standardised approaches. We are happy for our response to be shared between the regulators and for it to be made public.
3. Our views on these proposals necessarily reflect our interest in their impact on mortgage lenders and the mortgage market. Some aspects of our response may also be applicable to the rest of the financial services industry.

Executive summary

4. The context to this submission is the CML's response to the Basel consultation on the proposed revisions to the standardised approach to credit risk. Our view on these changes, are contained in a separate submission. However, in summary we have concerns with the proposals to change the standardised approach.
5. Given our concerns over the proposed changes to the standardised approach, we have confined our comments to the theoretical use of capital floors based on a standardised approach. The actual impact of any floors would be determined by the calibration of the revised standardised approach and that in our opinion needs considerable refinement from the changes outlined.
6. We, therefore, think that it would be more appropriate for the introduction and calibration of a new capital floor to occur after the conclusion of the revision of the standardised approach and time to allow regulators to assess the impact of any revision to the risk weights under the standardised approach before embarking on a review of the capital floor.

Key issues

7. The internal ratings based approach (IRB) is a sophisticated risk based approach to determine the appropriate level of capital to be held. It, therefore, seems counter-intuitive to overlay a less sophisticated approach over the IRB method that could potentially become the binding calculation determining the level of capital held.
8. Our concern is that with a capital floor the regulation is returning to a more simplistic approach to capital management. We believe that the risk drivers, including loss experience across business models and countries, is different and that, therefore, a universally globally applied capital floor is fraught with difficulty. It removes regulation away from the economic reality based on the models used by banks employing historic data use to calculate various variables which should, if applied correctly, produce a more accurate level of capital required for a given risk.
9. In addition, the proposals suggested, do not take into account the substantial changes in regulatory architecture already undertaken since the financial crisis. **On the one hand**, this includes a stiffening of the risk-based approach with the use of capital buffers etc. In addition, with the use of macro-prudential tools, in particular the leverage ratio, the regulatory framework now incorporates a non-risk base approach, designed to counteract some of the apparent flaws in the risk-based system.

This improved and structurally robust regulatory framework needs time to bed down and for regulators to understand how the various element of the system interact and interrelate. We, therefore, think that Basel should allow a period for regulators to gather evidence on the efficacy of the existing system before introducing further regulation.

10. The introduction of floors based on the revised standardised approach will, we believe have a disproportionate impact on high quality, low historic calculated risk IRB portfolios, particularly lenders with large mortgage books. This will adversely affect mortgage lending for consumers, both the supply and price of mortgages. Furthermore, it has the potential to influence the actions of lenders asset allocation i.e. switching lending from low risk mortgages to higher risk portfolios.

11. We would also highlight that within the IRB models various floor exist at portfolio level e.g. for Loss Given Default (LGD) and Probability of Default (PD), which already address the issue of models representing the risk of portfolios. We consider that these floors embedded within the models already provide regulators with the flexibility to tweak the IRB framework to account for national, idiosyncratic risks emerging in specific asset portfolios.

Specific comments

12. Regarding question 1 in the consultation paper, while we recognise that the use of an aggregated floor is easier to apply, a granular approach would allow a more risk sensitive approach across portfolios. Both approaches have their advantages and disadvantages and further detail is needed to assess how these different methodologies will affect different business models. Initially we would comment that an aggregated approach masks the different risks of asset portfolios within lenders and, therefore, potential favours universal banks over, for example, lenders whose primary asset portfolio is substantially mortgages.

13. This response has been prepared by the CML in consultation with its members. If you have any comments or queries on this response, please contact the CML representative Jon Saunders, Senior Policy Adviser: jon.saunders@cml.org.uk +44 20 7438 8934