

Second consultative document: Revisions to the Standardised Approach for credit risk

Submission by the Council of Mortgage Lenders to the Basel Committee on Banking Supervision

Introduction

1. The Council of Mortgage Lenders (CML) is the representative trade body for the residential mortgage lender industry that includes banks, building societies and specialist lenders in the UK. Our 134 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 Supervision's (BCBS) second consultation document: "[Revisions to the Standardised Approach \(SA\) for credit risk](#)". In preparing our response, we have engaged with our members and other interested trade associations, government departments and regulators. In addition, we have worked with the European Mortgage Federation (EMF). We are happy for our response to be shared between 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.

Overview

4. The revised proposals suggested within this second consultation have addressed some of the concerns we raised in response to the initial consultation paper (December 2014). There remain, however, a number of areas where we consider that the proposed changes will result in unduly harsh capital treatment for both prime and buy-to-let (BTL) mortgages; and that these changes do not reflect the underlying risk of the asset class. The proposals, if implemented in their current form, would, therefore, have unintended and negative consequences for both these sectors of the UK mortgage market.

5. We would emphasise that the proposals outlined by the BCBS are for *minimum standards*. It will remain the role of national regulators to increase capital requirements (should these be needed) for specific national market circumstances (see below for the actions of the UK regulators). Minimum standards should therefore be calibrated on the best practice/experience of specific national markets and then additional capital requirements overlaid where national regulators identify specific issues that move an individual market away from these markets.

6. Furthermore, the application of the methodology and proposed calibration suggested within the document would require financial institutions to raise additional capital. We are unconvinced of the need for additional capital within the banking system on the risks identified within the consultation document i.e. credit risk. We do acknowledge that regulators have identified other risks e.g. systemic risks that are addressed with the use of other regulatory tools rather than changes in risk weights (RWs).

7. In the UK mortgage market context, we question the suitability of the calibration proposed in the consultation document, both for prime residential and Income Producing Real Estate (IPRE). We believe that the historic loss experienced in both these markets does not justify the significant increase in risk weights proposed. Furthermore, given the regulatory changes already implemented at origination in the UK - i.e. the Financial Conduct Authority (FCA) Mortgage Market Review (MMR), which includes stress testing of affordability – historic loss data is, arguably, less relevant in calibrating (new) risk weights, given the new paradigm of underwriting the regulatory changes

introduced. The proposed changes to risk weights, therefore, seem to be calculated in a regulatory vacuum.

8. While this is a response to a consultation on changes to SA approach to credit risk, we will refer to data collected from IRB lenders. We believe that this data gives a useful insight to the risk parameters of various mortgage asset classes; and should therefore be taken into consideration.

9. While the revised methodology for prime residential mortgage lending does offer a more granular and risk sensitive approach, we continue to believe that taken as a whole, the methodology over-estimates the risk of the asset class. Further work needs to be undertaken, in conjunction with the industry, before a more risk sensitive model could be introduced. The evidence from IRB lenders would suggest that the proposed calibration of the risk weights for standardised lenders is still too high given the credit risk experienced by all lenders.

10. There is a balance to be struck between introducing increased risk sensitivity (which ultimately produces a more refined, accurate capital requirement into the SA approach) and maintaining simplicity and comparability of the SA approach across national jurisdictions. We believe that some of the proposals do not go far enough in terms of risk sensitivity and granular analysis to produce an improved capital calculation.

11. In line with our comments on prime residential, we believe that the methodology applied to IPRE needs further review. We would contend that the evidence from lenders questions the need for significant increases in risk weights for IPRE. Furthermore, we believe that a more granular model for calculating risk weights for IPRE - similar to that employed for prime residential - would be logical.

12. In relation to IRB lenders, we are anxious that, following a conclusion to the changes in the SA for credit risk, any potential changes to the floors within the IRB models also receive a full and comprehensive consultation with the mortgage industry. We would note that the calibration of the floor would have a crucial impact on the UK economy.

13. We welcome the recognition of social housing as a distinct asset class within the consultation paper. As we highlighted in response to the first consultation, social housing plays an important role in the UK mortgage market. It is our understanding that the proposals would place social housing on the same risk weight matrix as prime residential, which we believe is appropriate (subject to further modifications in the methodology, see below). Given the unique structure of the UK social housing market, we are also keen to ensure that the global designation of social housing within the proposals captures the entire UK market for social housing.

Specific comments relating to risk weights proposed for residential real estate exposures.

14. We welcome the flexibility included in the proposals to allow loans to individuals secured by residential property under construction (subject to certain caveats) to be assigned the risk weight treatment described in paragraph 54, subject to national discretion. We believe that this methodology should be extended to "custom-build" property under construction. Custom build homes are where an individual will work with; and have an individual contract with, a specialist developer to build a residential property for them. It can therefore, be seen as an extension of the self-build market and should be treated as such.

15. The complexity of the UK mortgage market means that there are a number of other products e.g. "shared ownership" or "lifetime" mortgages where the application of the proposed methodology is unclear. Further consultation is needed to establish how specific mortgage products would derive their RW under the proposals.

16. In addition, within the prime residential mortgage market, a number of UK lenders extend mortgages on an interest only (IO) basis. While the borrowers may have alternative repayment plans in place, in some circumstances, some or all of the repayment of the mortgage may rely on the sale of the residential property. This could lead this type of mortgage to be assigned a RW under the IPRE methodology and calibration. We, however, contend that as a principal residential property such mortgages should derive their RW from the methodology provided for prime residential lending.

17. With regard to the LTV calculation, the current proposals continue to allow national supervisors to require lenders to revise the property valuation downwards. While the proposals allow for a subsequent revaluation upwards, the value of the property cannot exceed the original valuation. We consider this perverse. In acknowledging that property markets go down, it is only logical to acknowledge that they also go up. In those circumstances, the LTV will change, which will have a material impact on the potential risk of the lending and loss given default.

18. Removing the upwards revaluation from on-going LTV calculations may remove some of the pro-cyclicality from the residential mortgage market. However, this further removes the capital calculation from economic reality. Both defaults and actual economic loss are significantly lower on seasoned loans where asset appreciation and principal repayments have been made, than less mature lending.

19. On a similar theme, we contend that lenders should be able to apply a blended risk weight by applying different risk weights for tranches of the loan. This is the methodology currently applied and reflects the overall risk of a loan. The current proposals produce significant cliff edge effects with the resulting distortion of the market and the potential for regulatory arbitrage that we consider undesirable. The difference in risk (probability of default and economic loss given default) between an LTV of 79% and 81% is minimal, but the effect of the proposals will significantly increase the capital required: a proposed risk weight of 35% for the former, versus 45% for the latter and an increase in the marginal capital requirement of 845%. The lack of tranching therefore further removes the capital calculation from the economic reality.

20. This effect is reduced by the methodology of loan splitting or tranching, which produces a weighted risk weighting, consistent with the current treatment of mortgage loans and the calculation of the RW for the entire loan. We would therefore recommend the re-introduction of a progressive approach, where a blended risk weight is applied to the total exposure to reflect the true comparative risk of the exposure.

21. In addition, lenders will capture changes in house prices at a number of points, including origination, further advances and restructuring debt. We believe that lenders should be able to take advantage of house price movements while undertaking these activities to allow for a more accurate, up to date picture of the economic proposition of the loan. Failure to take into account asset price changes may limit the ability of lenders to provide some products, e.g. further advances, to the detriment of the consumer.

22. We also have considerable concerns that if revaluation of asset prices and the tranching of the loan for calculation of risk weights are not allowed, this will create an economic incentive for lenders to increase further re-mortgaging opportunities. This could be to the detriment of high LTV lending for first time buyers and, in turn, increase demand for rented property (since FTB's would be unable to access the market). However, the potential changes in risk weights suggested in the consultation paper would suggest that lenders would be even more capital constrained to provide IPRE mortgages, resulting in less properties available to rent; and potentially higher rents.

23. The proposal makes no comment on whether lenders would have to undertake a re-weighting exercise for the entire back book, or whether the implementation would apply solely to new lending. The application of different risk weights would, we believe, be confusing for the market (and therefore lessen the impact that Pillar 3 has on influencing the activities of lenders); as well as being costly for lenders to implement in terms of system changes and upgrades. On the other hand, a full revaluation of lenders' back books to establish a current LTV would also be extremely costly: using historic LTV calculations at origination would, in a large number of cases, have no relation to the economic reality.

Specific comments relating to proposals to change the risk weights for residential real estate where repayment is materially dependent on cash flows generated by property (IPRE).

24. We recognise that the UK IPRE market has demonstrated a greater degree of volatility than the prime residential market, but that volatility is not automatically an indicator of greater risk. Thus, the IPRE market responds more quickly to external market factors e.g. a rise in interest rates, and quickly adapts. However, the IPRE market also more quickly recovers its equilibrium. A variety of factors enables these more rapid readjustments. Lenders employ different forbearance policies to

IPRE as opposed to prime residential but, for example, the ability of the lender to appoint a “receiver of rent” also enables the lender to recover arrears more quickly.

25. Furthermore, the majority of mortgages extended in the UK IPRE market are interest only (IO) mortgages. The mechanics of the operation of IO mortgages means that arrears develop quicker than capital and repayment mortgages but also, as highlighted above, the lender has alternative strategies to recover arrears more quickly. We therefore, do not think that use of arrears within the IPRE sector of the market as a complete or reliable indication of risk.

26. We continue to believe that data collected from lenders using the IRB methodology provides the most compelling evidence of the risk in the IPRE sector. We contend that the calibration of SA RW's, based on available IRB data, provides the basis for a level playing field between IRB and SA RW's, to prevent regulatory arbitrage between the calculations of capital requirements under different methodologies.

27. Given the above, we have consulted with a number of our members using the IRB typology to establish their view of the appropriate risk weights for the IPRE sector. In conclusion they would highlight the following points:

(a) The establishment of RWs through the cycle for IPRE is extremely difficult. Historic data collection i.e. for the cohort of BTL originated pre-crisis (<2008) is patchy. Given the events around the financial crisis and the change in approach of IPRE origination (including regulatory intervention), we believe that IPRE originated post crisis reflect different risk parameters and therefore it is difficult to compare the risk associated with pre and post crisis IPRE origination.

(b) Notwithstanding this, from the data provided we would highlight some conclusions. At low LTVs the evidenced PD and LGD for IPRE vs prime residential shows little difference. Indeed, some IPRE books show a lower PD and LGD than their comparable prime residential cohorts at very low LTVs. We would conclude that IPRE lending books have mostly demonstrated lower PD's but higher LGD's but the effect on the move in these variables are largely offsetting.

28. The evidence for PD and LGD for higher LTVs is less consensual. Some asset books demonstrate lower risk parameters than their prime residential peers across LTVs, while other books show a slight pick up in the risk of IPRE books as LTVs increase. However, consistent across the data collected that even for IPRE mortgages with LTVs between 60%-80%, the increase in risk is not the circa 2.5X that is implied with the calibration proposed in the document (an increase in RW from 35% to 90%).

29. In addition, we have garnered data from members using the SA methodology. Again, the evidence provided suggests that at low LTV's i.e. below 80% that the loss rate experienced through the cycle is extremely low. For example, for one large lender within the BTL sector, their loss experienced between 1996-2005, for IPREs advances with an LTV less than 50%, was only 0.03%. This rose to 0.14% for loans advanced with an LTV of between 70-80%. Both these figures compare extremely favourably with the experience lenders have for prime residential mortgages. We would acknowledge that at LTV's above 80% lenders do experience higher loss rates (again similarly to prime residential). In the case above for IPRE loans with an LTV of greater than 90%, the loss experience was 3.15%.

30. Our view is that IPRE should follow the same methodology as prime residential. In this regard, we therefore feel the proposed LTV matrix lacks granularity: rather than three LTV buckets we would propose six buckets following the methodology proposed in Paragraph 9.1 and table 9 of the proposal. This would enable a more nuanced view of the risk of individual loans to be established. As above, we would also suggest that an average weighted risk weight should be used i.e. the application of tranching/splitting of loans and revaluation (both up and down). Should the BIS wish to proceed with an amended methodology, we would suggest a further consultation to be undertaken, to review both the appropriate risk buckets as determined by LTV and calibration.

31. We would also highlight that we are surprised with the apparent conclusion in the document that IPRE mortgages (a secured asset class) warrant a higher risk weight at certain LTVs than unsecured retail exposures (Paragraph 1.4.1).

32. In addition, we would note that the proposals on IPRE may also affect other sectors of the market e.g. lifetime mortgages. Given the demographic challenges of an ageing population, lifetime mortgages are likely to play an increasing role in the financing of property, but the ability for lenders to provide this product will be restricted with the application of higher risk weights.

Specific comments relating to proposals to change the risk weights for social housing

33. We welcome the amended treatment of lending to social housing associations (see Paragraph 56 and the related footnote 50). We note the “intent” to exclude lending to social housing associations from the proposals, but that the wording is such that it may be ambiguous; potentially leaving substantial parts of the UK social housing market in scope. BIS standards are by definition global standards and therefore may miss the subtle nuances of domestic markets. We therefore propose alternative wording to capture the UK social housing market, as below.

34. We suggest that footnote 50 be amended to reflect the current situation in some national markets and therefore proposed the following wording:

“Also excluded are loans to [UK]registered providers (Housing Associations and social housing landlords) of social housing that are regulated nationally within an overall policy environment set by government. In the UK, social housing policy and regulation is overseen by the UK’s devolved nations. Authority to determine whether a national regulator existed for the social housing sector would, in the UK, be derogated to the PRA.”

35. Given that lending to social housing is excluded from Para 56, lending to social housing associations would derive the appropriate risk weight from the LTV / Risk weight matrix within the consultation document (Para 54). We would re-iterate that for this matrix to be applied, lenders should be able to tranche their exposure to reflect different risk weights for a given LTV. Furthermore some form of revaluation of properties should also be included to reflect the movements in the housing market; to more accurately reflect the given risk of a loan rather than relying on potentially substantially historic data.

Other Comments

36. In addition, we note there is a proposal for ADC loans to be assigned a RW of 150% irrespective of the classification of the provider of the loan (individual, builder, developer or corporate). This is likely to have a significant impact on lender to the house builder sector, which in the UK has the potential to further exacerbate the supply/demand imbalance and result in rising house prices.

37. We would also note that the 50% add-on for foreign currency mismatch is unwelcome. No evidence has been supplied to justify this calibration.

38. 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 Jon Saunders, Senior Policy Adviser: jon.saunders@cml.org.uk +44 20 7438 8934