Basel Committee on Banking Supervision
Second consultative document on Revisions to the Standardised Approach for credit risk

A response by the Intermediary Mortgage Lenders Association, London, UK

4th March 2016

Introduction

1. The Intermediary Mortgage Lenders Association (IMLA) welcomes the opportunity to respond to the Second consultative document on Revisions to the Standardised Approach (SA) for credit risk published by the Basel Committee on Banking Supervision in December 2015. We are happy for our submission to be made publicly available.

2. IMLA is the representative trade body for mortgage lenders who lend through intermediaries. Our members include banks, building societies and specialist lenders.

3. IMLA's views on the proposals contained in the consultation reflect our members' concerns. Our main interest in the consultation relates to those proposals that affect the operation of the mortgage market.

Summary

4. The Basel framework is design to ensure that deposit taking institutions such as banks and building societies have sufficient capital for the risks they run and that the capital that they hold provides them with appropriate incentives to manage that risk. The Basel framework therefore depends upon a dispassionate interpretation of the evidence of risk carried by different classes of exposure.

5. With these objectives in mind, our main concerns with the proposals set out in the consultative document are as follows:

a. The proposal to split exposures secured on residential property into separate classes, where repayment is and is not materially dependent on the cash flow generated by the property, is not justified by differences in risk. Residential property is a single class of asset served by a range of different forms of mortgage product. Evidence of differences in risk between mortgage products is not sufficient to justify stratifying this class of lending in the form proposed.

b. We do not support the consultation proposal that risk weights of loans secured on residential property should be stratified by LTV band with risk weights applied across the whole exposure rather than on each specific LTV tranche as is currently the case. Applying risk weights determined by LTV to the whole exposure has the effect of distorting capital relative to actual risk. We therefore call for tranching to be retained.

c. The proposal to require that property is revalued downwards in the face of movements of market values but cannot be revalued upwards for the purpose of determining the LTV band into which an exposure falls, will significantly distort the allocation of capital relative to actual risk. We would argue that lenders should be able to adjust the value of the security upwards for the purposes of calculating the LTV band where the underlying value of the security has risen.

d. We believe that the proposal that floors should be imposed on lenders using the IRB approach, read across from the capital calculation determined by the adjusted Standardised Approach (SA), has the potential to distort the allocation of capital and penalise lenders that have adopted conservative lending standards. No decision should be made on capital floors until changes to the SA have been finalised, implemented and have had time to bed down.

e. The aggregate effect of the proposals to introduce separate risk weights for income producing real estate (IPRE) exposures secured on residential property, not to allow upward revaluation of property for the purposes of determining LTV band and not tranching risk weights by LTV band, will be a substantial increase in total regulatory capital which is not justified by historical evidence from mortgage losses and runs contrary to the stated aims of the consultation.

Objectives of the consultation

6. Section 3 of the consultation sets out its aims which include:

Ensure the SA is appropriately calibrated to reflect to a reasonable extent the riskiness of exposures

Under the heading Next steps, the consultation reminds readers that:

Increasing overall capital requirements under the SA for credit risk is not an objective of the Committee; rather, capital requirements should be commensurate with the underlying risk.

7. IMLA supports these objectives and is concerned that the proposals as currently drafted do not meet these stated aims.

IMLA's detailed response

8. For the most part, the consultation achieves its aim of increasing risk sensitivity and maintaining consistency with the IRB approach while ensuring that capital requirements are commensurate with the underlying risk. However, we do have significant concerns with some of the proposed changes and these are set out in our detailed response.

Introduction of separate scale of risk weights for income-producing real estate (IPRE) exposures secured on residential property

9. We strongly disagree with the proposal to introduce a separate scale of risk weights for IPRE exposures secured on residential property.

10. This proposal constitutes a huge departure from the past practice of accepting residential property as a single class of security. It gives rise to the risk that, based on the evidence we have available, risk weights will not reflect underlying risks, giving rise to the potential for capital requirements to be materially distorted.

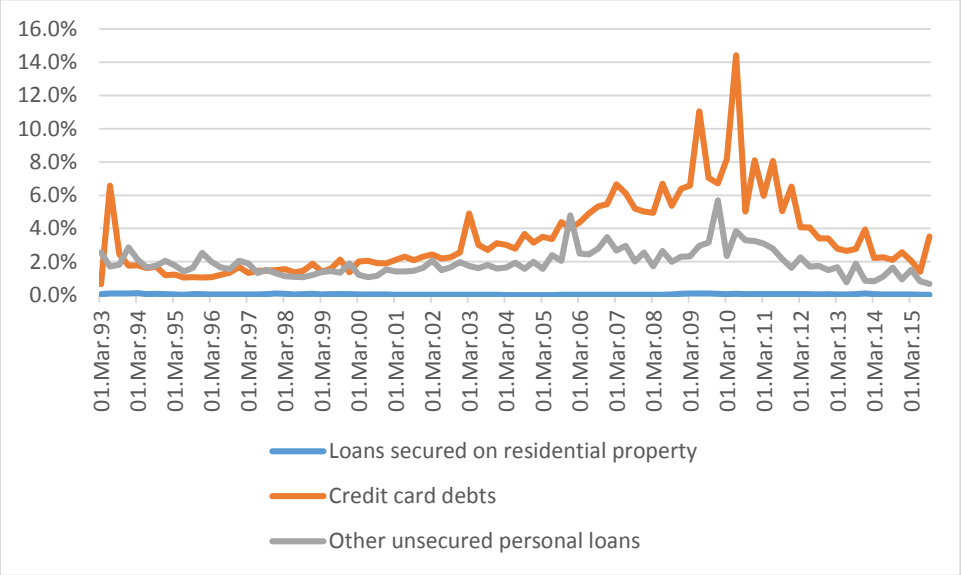
11. Under the proposals, residential IPRE would face risk weights of up to 120% and 70% even for the lowest category of risk (loans up to an LTV of 60%). This represents an increase in risk weights of up to 257% for some exposures and of 100% even for the lowest risk exposures. Somewhat bizarrely in our view, exposures of more than 60% LTV would carry a risk weight exceeding that of unsecured exposures in retail portfolios, which carry a 75% risk weight.

12. It is unclear how the Basel committee arrived at the risk weights proposed for IPRE. But it seems self-evident that it cannot be based on any dispassionate interpretation of factual evidence given the far higher rates of default and loss typically experienced on unsecured retail exposures. Frankly, for an exposure secured on residential property to carry a higher risk weight than an unsecured retail exposure to the same customer is so perverse that it undermines the credibility of the Basel regime.

13. Although in the UK there is no published industry-wide data on write-offs broken down between income producing residential property (buy-to-let) and lending to owner-occupiers, we can draw on a range of data to get a feel for the relative riskiness of lending secured on residential property where repayment is and is not materially dependent on the cash flows of the property.

14. This can be compared to write-offs on unsecured lending to individuals for which published data does exist. Chart 1, which is based on data from the Bank of England, shows write-off rates (write-offs as a percentage of outstanding balances) for lending to individuals, broken down into lending secured on residential property, credit card lending and other unsecured lending.

Chart 1 – UK annualised loan write-off rates, 1993 to 2015

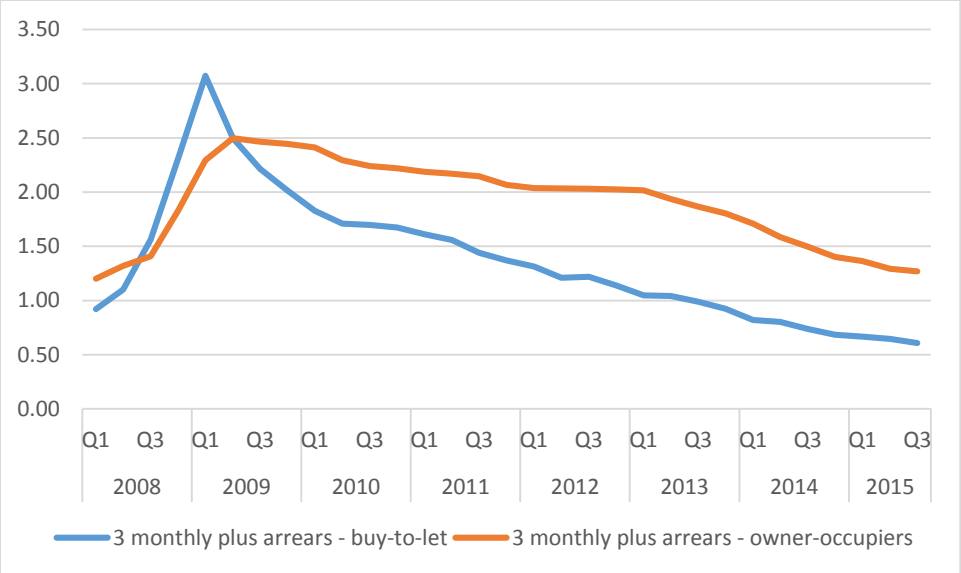


Source: Bank of England

15. Chart 1 illustrates the enormous difference in write-off rates between secured and unsecured lending to individuals. Over the period Q1 1993 to Q3 2015, annualised secured lending write-off rates averaged 0.038%, peaking at 0.107% in Q1 1994. Over the same period annualised write-off rates for non-credit card unsecured lending averaged 1.947%, which is 51 times the rate for secured lending. The write-off rate reached a peak of 5.697% in Q4 2009 while the standard deviation was also 32 times that of secured lending.

16. Credit card lending write off rates were higher still, averaging 3.472% between 1993 and 2015, 92 times the level for secured lending. Credit card write-offs peaked at an annual rate of 14.415% in Q2 2010 and the standard deviation of quarterly write-off rates was 94 times that of secured lending over the same period.

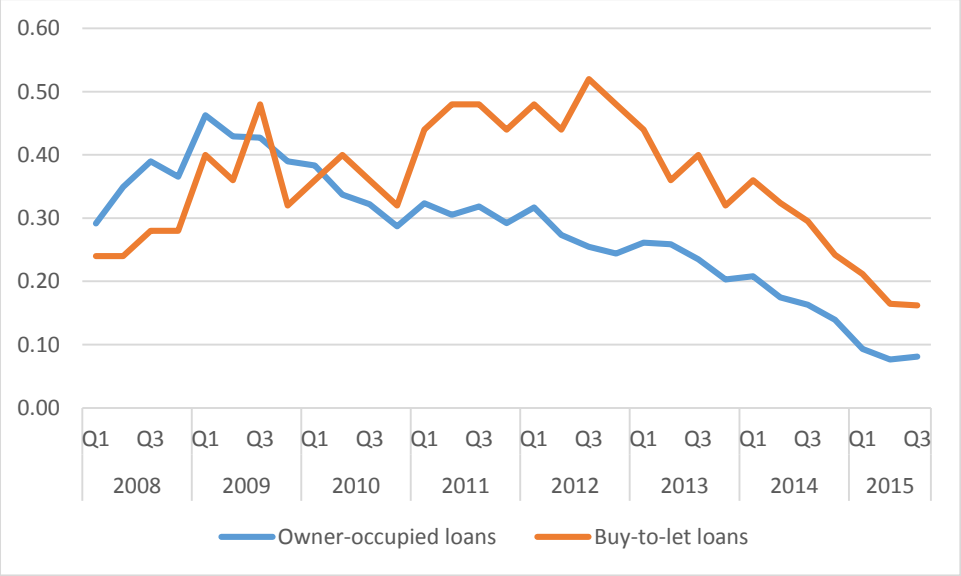
Chart 2 – Three month plus UK mortgage arrears, 2008 to 2015



Source: CML

17. Turning to the differences between lending to owner-occupiers and buy-to-let investors, Chart 2 shows the **rate of 3 month plus arrears**. For most of the period since 2008 arrears on buy-to-let loans have been lower. On average, over this period, 3 month plus arrears have averaged 1.37% for buy-to-let loans and 1.91% for owner-occupied loans (0.54% or 39% above the rate for buy-to-let). By contrast, Chart 3 shows that the **rate of possession** has been higher for buy-to-let over this period, averaging an annualised rate of 0.36% against 0.28% for loans to owner-occupiers – 28% higher.

Chart 3 – UK properties taken into possession (% of total – annualised rate)



Source: CML

18. Lenders also report that write-off rates are higher for buy-to-let loans. Although the differential varies between lenders, on average it seems that write-off rates on buy-to-let lending may exceed those on loans to owner-occupiers by a similar ratio as possessions. This is perhaps unsurprising given that possessed buy-to-let and owner-occupied properties are both sold into the broader residential property market. The best performing buy-to-let loan portfolios have substantially lower write-off rates than the average for owner-occupied lending.

19. What is important to understand is that although there are safeguards for tenants, the protocols around repossessing rented property are less time consuming than for owner occupiers in default. This alongside a greater willingness by the courts to allow lenders to take possession of landlord owned property impacts upon the relative rates of possession but gives the lender more control over arrears cases.

20. Compared to the differences between write-off rates for secured and unsecured loans, the differences between classes of loan secured on residential property cannot sensibly be considered material. To institute an entirely separate scale of risk weights therefore makes little sense, even less so one that exceeds the weights applied to vastly riskier unsecured exposures.

Read across between proposals for commercial and residential property

21. Reading the explanation provided in section 1.5 of the consultation paper it seems clear that the proposal to introduce the specialised lending sub-categories of residential IPRE and acquisition, development and construction (ADC) is designed to ensure consistency between the treatment of exposures secured on commercial and residential property.

22. While there is a clear logic to imposing consistent ADC sub-categories in both commercial and residential markets as development and construction activity is of a similar commercial and often speculative nature, we would question the logic of imposing a residential IPRE sub-category. Lenders understand the clear distinction in risk between lending secured on existing residential properties and loans for the development of residential property – i.e. where a loan is advanced before a completed residential property exists.

23. As the above analysis of loan distress illustrates, the distinction between a residential real estate exposure and a residential IPRE exposure is artificial. Security is ultimately realised by sale into the broader housing market, ensuring that loss rates are unlikely to diverge too far. Indeed, loss rates on sale are likely to be influenced far more by market conditions in different geographical locations than by the difference between previous rented or owner-occupied status.

24. Moreover, the consultation is clear in identifying the source of risk as coming from commercial property: *'Given that commercial real estate lending is a recurring source of troubled assets in the banking industry, the current standardised approach sets a flat 100% risk weight on most exposures secured by mortgages on commercial real estate.'*

25. Yet in establishing an IPRE sub-category, even though the suggested scale of risk weights is slightly lower for residential IPRE than for commercial IPRE, because the starting point is a 35% risk weight rather than the 100% for commercial property under the existing SA framework, the proposed increase is vastly greater for residential property despite the Basel Committee's apparent concern about commercial rather than residential rented property. This cannot be justified.

26. One major weakness of the proposal for IPRE based on LTV buckets is that the lender is not able to take account of the financial strength of the borrower. This can lead to the bizarre situation that lending unsecured can give rise to a lower risk weight than lending secured to the same borrower.

27. This has ramifications both for exposures secured on commercial and residential property, but one of the most serious examples of its potential is with regard to lending to UK housing associations secured on residential property. The proposals as they currently stand could see loans to many housing associations defined as residential IPRE and therefore subject to the extreme risk weights explained above, despite the exemplary payment track record of UK housing associations and their government regulated status.

28. But more broadly, many buy-to-let borrowers are substantially more financially secure than the average owner-occupier and the proposed approach cannot accommodate this

fact. Within the UK, there are IPRE lending portfolios with write-off rates that are higher than the average for residential lending and some that are lower. Where the regulator believes the risks are sufficiently higher to warrant additional capital, this can be prescribed under Pillar II. To implement a proposal that indiscriminately raises risk weights even where buy-to-let lending portfolios have suffered lower than average residential lending losses will give rise to perverse capital requirements.

Use of LTVs to determine appropriate risk weight

29. The consultation states: '*QIS data show that the loss incurred in the event of a default and the likelihood of a borrower's default are lower when the outstanding loan amount relative to the value of the residential real estate collateral is lower*.'

30. We concur that LTV is an appropriate risk metric for exposures secured on residential property. Experience shows that higher LTV loans tend to give rise to higher losses on default while the likelihood of default has also been shown to be higher at higher LTVs. This is especially true where the LTV at origination is 100% or above.

31. But it should be noted that where LTVs are below 100% but still high (say 90- 95%) many borrowers have invested what is still a large proportion of their own wealth in the property (the average first time buyer deposit at 90% LTV is in the region of £30,000) and will prioritise payments in even the most adverse circumstances. This highlights the fundamental strength of secured lending to individuals which has underpinned its traditionally outstanding credit quality where the borrower has committed a substantial stake of their own funds at inception.

Tranching of risk weights within LTV bands

32. We strongly disagree with the consultation proposal that risk weights for exposures secured on residential property should be determined by the LTV ratio on an untranched bases (i.e. that the risk weight should apply to the whole loan rather than separate risk weights being applied to each specific LTV band).

33. Applying a higher risk weight to high LTV loans across the whole exposure is less likely to produce a risk weight that accurately reflects the additional risk than one where the higher risk weight is applied, appropriately, to each separate LTV portion. As a result, it is likely to reduce consistency with the IRB approach undermining one of the key aims of the changes which is to *increase comparability of capital requirements under the SA and the IRB approach by aligning definitions and taxonomy where possible*.

34. The proposal will also create discontinuities at the boundaries of LTV bands that will likely distort mortgage pricing. For example, under the current proposal an 80% LTV loan will carry a 35% risk weight while an 81% LTV loan will carry a 45% risk weight. At the margin, the implied risk weight on the portion of the loan above 80% would in this case be 845%.

35. Were the proposals to be enacted in their current form lenders would need to raise the price of higher LTV loans, which could incentivise borrowers to seek out unsecured top-up

loans to allow them to borrow at a lower LTV ratio on a secured basis. This distortion would be potentially harmful to borrowers.

36. Applying the higher risk weight across the whole exposure is also likely, given the suggested risk weights, to substantially increase the total amount of capital that mortgage lenders are required to hold, contrary to the consultation's objective of not increasing total regulatory capital.

Proposal to use property valuation at origination to calculation LTV

37. The consultation states: *While the value of the property (i.e. the denominator of the LTV ratio) would be kept constant at origination, supervisors may require banks to revise the value downwards in case of a general decline in residential market prices.*

38. We strongly disagree with proposals to create an asymmetry of treatment where LTV is adjusted down when the property has suffered a material fall in value but to disallow any adjustment to LTV when the property has risen in value.

39. This proposal has the potential to distort the risk sensitivity of capital requirements by failing to recognise changes in property prices over the life of a loan and to create a distortion relative to the IRB approach. Instead we believe that underlying upward changes in property values need to be reflected in the LTV calculation to avoid distortions in capital treatment between new loans and seasoned ones.

40. Indeed, in lenders' experience more 'seasoned' loans (those that have been on the books for longer periods of time) tend to exhibit lower rates of default and lower losses. To implement a policy that effectively discriminates against seasoned loans against a background of rising property prices is likely to provide a misleading capital requirement.

The combined effect of tranching and non-indexation of property values

41. The combination of tranching and an inability to revalue property upwards risks creating a particularly pernicious distortion to risk weights whereby they may utterly fail to reflect the genuine level of risk lenders are exposure to.

42. For example, consider an interest only loan made at an LTV of 95% on an average priced UK property in 1995 (which was £62,000 based on Halifax house price data). With average UK house prices reaching £203,000 by the end of 2015, the same loan might now have an LTV of 29%. Under the approach being proposed in the consultation this loan would have to be recorded as 95% LTV in 2015 with the whole loan subject to the corresponding 55% risk weight.

43. Were the customer to remortgage the risk weight would fall to 25%. So the proposed approach would create an artificial incentive to lenders to remortgage or churn customers and would leave the SA unable to accurately reflect lenders' genuine risk. We do not believe this is an outcome that Basel Committee would determine was good either for customers or lenders.

Imposition of capital floor to IRB approach

44. To address the variability in risk-weighted assets across banks using the IRB approach, the Basel Committee has raised the prospect of imposing floors on risk weights generated using lenders' internal risk models (see consultation *Capital floors: the design of a framework based on standardised approaches* December 2014).

45. While potentially increasing the co-ordination of the IRB and standardised approaches, such floors have the potential to distort the relationship between IRB lenders' risk weights and their actual risks. Lenders who have implemented lending and servicing procedures that minimise risk will no longer necessarily receive a corresponding benefit in their risk weights, undermining one of the key incentives in the Basel IRB framework.

46. We do not believe that the Basel Committee should implement capital floors until any changes to the standardised approach are agreed, implemented and have had time to bed in. Furthermore, we would be concerned if any floors were set too high as this would only exacerbate the shortcoming discussed in the paragraph above.

Further information

47. This response has been prepared by Rob Thomas and Peter Williams, Executive Director of IMLA in conjunction with the Directors of IMLA. If there are any questions or comments these should be directed to Rob Thomas 07864124962 rob.thomas@instinctif.com or Peter Williams on 07718120858 and consultpwilliams@btinternet.com