

RESIDENTIAL LANDLORDS ASSOCIATION

RESPONSE TO THE BASEL COMMITTEE ON BANKING SUPERVISION – SECOND CONSULTATIVE DOCUMENT : STANDARDS : REVISIONS TO THE STANDARDISED APPROACH FOR CREDIT RISK

About the Residential Landlords Association (RLA)

The Residential Landlords Association (RLA) is the premier national landlords Association operating in England and Wales. We have over 20,000 subscribing members and a further additional 20,000 members. Our members own or control over 250,000 units of accommodation. As a representative trade body our role is to represent residential landlords to the UK and Welsh Governments, Parliament and Assembly. We are work in alliance with the Scottish Association of Landlords to provide representation throughout the United Kingdom. Primarily our members are private residential landlords in their own right but a number are managing and letting agents, some of whom are also landlords. Our members operate in all sub-sectors of the Private Rented Sector (PRS). Properties are rented out to families, working people, young professionals, the elderly, students and benefit claimants.

We are in regular communication with the UK Government, its various departments and the Welsh Government to discuss PRS related topics. We respond to Government and other consultations and propose changes to legislation and policy applicable to both the PRS and the wider housing market.

Introduction

As one would expect from a trade body representing residential landlords in the PRS in England and Wales, this response purely addresses risk weightings relating to mortgages on residential estate where the repayment of the mortgage loan depends materially on the cash flows generated by the property. This is a sub-category within the new proposed real estate exposure class. In the United Kingdom this is colloquially referred to as buy to let mortgages. For ease we also adopt this description.

We can understand the advantages in grouping loans together where these are serviced by cash flows and we have to recognise that residential loans of this kind are inherently different from mortgage loans secured by owner occupiers on their own homes where they reside.

Our members, as landlords, who borrow on buy to let mortgages will be especially affected by these proposals. However, equally importantly, so will landlords who have no borrowings, tenants and prospective tenants as well as the wider private rented sector together with the housing market more generally.

Nevertheless, for the average young couple looking to rent a home, the impact of the Basel Committee and these proposals must appear totally remote. Ostensibly, the proposals are about the arcane requirements under banking regulation as to how you calculate the capital adequacy of banks. We recognise the need to ensure that banks have adequate capital to meet economic shocks and to become more resilient but this cannot operate in isolation. The reality therefore for our imaginary young couple is rather different. Although they will not realise it these proposals are likely to have significant social and economic consequences so far as housing provision is concerned in jurisdictions such as the United Kingdom which are heavily and increasingly dependant on private market residential housing. Whilst we recognise that Banks have to increase their resilience decisions made by the Committee will affect private residential lets, since buy to let rental markets are dependent for their operation on bank and other similar financing.

It is therefore important that policy makers on the Committee appreciate this direct link between what they decide and how it impacts on the ability of tenants to find rental properties as well as the amount of rent which they will have to pay. If adopted, the changes proposed to risk weightings will result in increased costs of borrowing for landlords and, potentially, less availability of funding for the acquisition of rental properties by landlords, due to these extra costs. Reduced supply of properties and/or increased cost of borrowings in turn flows through to and influences rental levels.

UK housing crisis

The UK faces a severe housing crisis due to a rising population resulting from positive net inward migration increasing as well as an aging population. 250,000 new homes a year are needed but only around 135,000 – 150,000 per annum are being built. Owner occupation levels are falling relative to other tenures. The PRS has expanded up to around 4.4 million homes due to increased demand. Social housing is insufficient. Increasingly families in particular who would look to social housing for their homes are now dependent on the private market rental sector.

All of this has resulted in upward pressure on house prices. There are, of course, regional variations but pressure is most acute in London and the South East. Other cities and towns elsewhere are not immune.

As demand for private rental housing has increased, the buy to let mortgage has been a key contributor to expanding the supply of private rental housing. Therefore, if what the Committee is now proposing is adopted, with consequent upward pressures on the cost of borrowing or, if some lenders withdraw from this segment of the market as a result, then it is going to be both harder and more expensive for landlords to fund borrowings to continue to meet increasing demands for additional supplies of rental housing.

Our main concerns

Our main concerns are as follows:-

- The level of the risk weightings proposed to be assigned to residential buy to let mortgages which when compared with other proposals particularly owner/occupier loans and ADC loans are too high.
- How ability to repay will be assessed for buy to let mortgages and, particularly, our concerns are that debt service coverage is not the most appropriate measure.

- The consequent adverse impacts for the UK private rental market which we have already outlined in brief
- The role of the Basel Committee and the resulting impact of these proposals, if implemented, alongside national regulation.

Proposed risk weightings for buy to let mortgages.

The function of the Committee is, of course, around bank regulation with the remit of ensuring that banks are resilient especially in times of economic down turn. The consultation sets out their objective succinctly. The standardised approach is intended to be a global minimum standard and therefore it is not possible to take into account all national characteristics in its approach.

We are of the view that the risk weightings proposed to be assigned in relation to the buy to let mortgages are arbitrary but their real impact is due to their significant increase above their current level. They will also be set at too high a level relative to owner occupier loans, if the proposal is adopted. There is no rationale put forward to justify what is proposed.

The risk weightings proposed for individuals (according to Tables 9 & 10) are:-

LTV Ratio	Buy to Let	Owner occupier
Up to 60%	70%	25%/30%
60% - 80%	90%	35%
Above 80%	120%	45%/55%/75%

Currently, all of the above are rated at 35%.

Separately, where land acquisition development and construction (ADC) exposures are involved the risk weighting would be 150%.

At the outset, we do not disagree with the idea that loan to value ratio should be the key risk driver. The size of the borrowings relative to value and the level of "equity" in a property which provides a buffer against losses in the event of repossession, are, we accept, a significant factor.

The Committee needs to remind itself that its role in this instance under the standardised approach is to set a minimum in terms of an appropriate risk weighting, as an alternative to an individual risk based approach as adopted particularly by larger international banks so this is the fall back.

However, in setting this minimum and allowing its use by individual banks and lenders, the Committee is also laying down the following criteria:-

- There must be sound underwriting criteria in place.
- There must be proper independent valuation.
- National regulators have power to fix higher ratings according to local conditions.

Additionally importantly collateral is provided and this is an inherent requirement for this categorisation to apply.

All of these requirements in themselves impose significant constraints on exposure to risk. Since these rigorous underwriting criteria have to be met to even qualify for the standardised approach we are of the view that from the outset there is a big question over the changes to the present risk weighting which are being suggested by the Committee.

Therefore, the scenario in which the minimum is being set is already a very "conservative" one anyway. In the light of this, three things particularly concern us. Firstly, the narrower gradations which apply in risk weighting in Table 9 (repayment not materially dependent on cash flows from the property) as against the more broad brush approach broader bandings adopted in Table 10 (for buy to let loans). Of even more concern, however, is the high relative differences between the two types of loan across the board, risk weightings assigned to buy to let lending are more than twice those applicable to owner/occupier lending, even though the latter traditionally carry higher loan to value ratio exposures.

Thirdly, where is the evidence on which these proposals are based? With respect, there is every sign that these are simply figures "plucked out of the air". In our view, it is important to produce data and evidence based on experience showing

likelihood of default and consequent loss on default ,including comparison between buy to let and owner occupier loans,, but this has not been done. Despite this, important decisions are being made which as we have already argued, will have important social and economic consequences for housing provision in the private rented sector. The Committee must, we feel, have regard to the consequences of its actions and should be able to justify why these decisions are being taken.

In the private rented sector in the UK, the total value of rental properties is of the order of £1 trillion (as against a total value of all quoted companies being of the order of £1.8 trillion). This demonstrates the importance of this sector to the UK economy. It is, however, a relatively lowly geared sector. The Bank of England estimate that about 50% of rental properties are subject to loans. Overall, buy to let borrowings total approximately £200 billion. Therefore, overall gearing of the sector is of the order of 20%. A considerable number of landlords who do borrow have gearings in the order of 50% or less. Even for those who are more highly leveraged commonly borrowings are around 60% - 80% with perhaps a 85% as a maximum. Indeed, in many cases underwriting criteria for lenders are set at no more than 65% loan to value.

On the other hand, for owner occupiers who are first time buyers a 90% mortgage is very common.

So far as buy to let lending is concerned, none of the above paints a picture of a high risk over borrowed sector. Indeed, it is fair to say that the sector has come through the Great Recession which started in 2008 relatively unscathed. In the light of this we believe that the proposed new risk weightings for buy to let mortgages are an over reaction.

As our comparison table above demonstrates, a risk weighting is being ascribed in the 60% - 80% loan to value category of 90% for buy to let lending as against 35% for equivalent owner occupier loans. We find the idea that the likelihood of default/cost of default is going to be over twice as much in the buy to let sector as the owner occupiers sector to be unbelievable in the light of available evidence and lenders' experiences, especially in the light of the conservative underwriting criteria to which we have already referred.

Further neither does the proposed differentiation between the two categories of lending make sense when you look at the different nature of who is an archetypal landlord. Most buy to let borrowers are more mature, they are in business, and they have other sources of income and assets. It should never be forgotten that in jurisdictions such as in the UK there is right of personal recourse to the borrower, anyway. We comment on this particular aspect of bankruptcy laws separately.

Further, neither does this different treatment between the two categories make sense when you think about the up to 60% loan to value category (which would include many buy to let borrowers). The risk weighting to be ascribed is 70% whereas it is only 45% for an owner occupier who borrows 90% on a loan to value ratio. Therefore, again, it is unbelievable that a lender is going to run the risk of such significant higher risk of default in the case of a buy to let borrower who has 50% borrowed as against an owner occupier who has 90% borrowed.

At a recent conference organised by Paragon a leading buy to let lender (the Paragon Great Buy to Let Mortgage Debate) and another specialist lender Mortgages for Business challenged the claims inherent in the Committee's proposals regarding the likelihood of default against the quality of buy to let mortgages. They both said that the Committee's proposals are not in line with their own experiences.

Internationally, there is a growing amount of literature on the subject of mortgage default, although this is still limited in scope. The Committee will be aware of a parallel consultation in the UK by the Treasury on local regulatory powers in relation to buy to let lending. In support of their case, the Treasury Consultation has drawn heavily on a paper written in 2014 by F McCann for the Central Bank of Ireland (Central Bank of Ireland, Technical Research Paper 18/RT/14). This is based on certain Irish Banks exposure to buy to let lending in the UK market and, in effect, this research is using the Irish Banks experience as a proxy for what has happened in the UK market. We believe that the general approach adopted in this research is open to question. Notwithstanding this concern, according to McCann in the period 2009 to 2013 their research found that the probability of default for buy to let mortgages was 36% higher than owner occupied mortgages. Even if this is right (although we would question this considering that it could be lower) it again raise a

serious question mark around relative weightings that are proposed to be ascribed to buy to let lending on the one hand and owner occupier lending on the other. All of the evidence points to the fact that the differentials set out in Tables 9 and 10 respectively are to say the very least highly questionable. It would therefore be wholly wrong, in our opinion, to adopt these without proper research and evidence which is transparent.

The further point to make is that it seems strange to ascribe weightings in Table 10 of 90% for a loan to value ratio of up to 80% and 120% where the loan to value is above 80% but only attach a risk weighting of 150% to this much more risky area of land acquisition development and construction. It seems strange to us, to say the least, that such a risky enterprise where lending is on a bare piece of land or property in the course of construction is only to be weighted at 150% as against a property which is let according to sound underwriting criteria on an income earning basis.

Therefore, looking at how buy to let fits into the overall pattern as between owner occupier mortgages on the one hand and ADC loans on the other hand using a loan to value ratio of 80% as a yard stick setting the risk weighting at 90% relative to the applicable level for owner occupier loans at 35% and ADC loans set at 150% is to fix the weighting for buy to let loans at too high a level and we consider be set at a lower level than that now proposed with related changes for other loan to value bandings.

Underwriting criteria – ability to pay

We agree that it is important to set appropriate underwriting criteria in order to apply the standardised approach, bearing in mind the Committee's remit to a minimum applicable across the jurisdictions. Having said that, in the case of buy to let mortgages the important point is to use an appropriate metric as the appropriate criteria when considering buy to let lending. We do not believe that debt service coverage is the correct starting point in this exercise for buy to let lending. The borrower's ability to repay the loan and creditworthiness need to be properly assessed and it is this principle which should be at the forefront; not a requirement to use debt service coverage as the metric. In any case, as we explain below, the

wording of the consultation is far from clear as to what is the metric to be utilised in this situation.

In the earlier consultation the Committee proposed that along with loan to value ratio, debt service coverage should be one of the two pillars of the new regime for buy to let lending. Rightly, in our opinion, this idea has been rejected for reasons given.

Nevertheless, we are concerned that debt service coverage could still be brought back in via the back door as part of the key underwriting criteria. We do not believe that this is the most appropriate measure for determining the ability to pay/credit worthiness in the buy to let loan subcategory. Property income is key.

There is a fundamental reason why such a significant role should not be assigned to the debt service coverage in the context of buy to let loans. This arises from the basic nature of the subcategory of loans under consideration, those where repayment is materially dependent upon cash flows generated by the property (or presumably where this is the case a portfolio of properties). If the reason for different treatment of this type of loan is the view that loan performance is dependent on receipt of income or capital from the properties then it is the ability of the property itself to generate income or capital which should be the main determinant in assessing ability to pay, although not exclusively so. Otherwise, it is simply illogical to create this subcategory so as to define the treatment to be applied to this type of loan by reference to its ability to produce a cash flow.

It should also be open to lenders to take up factors into account and particularly if this is not satisfactory it may be appropriate to look at other sources of income to supplement property cash flows. Likewise, it would be appropriate to look at the borrower's position overall in relation to both the income and indebtedness so as to ensure that a borrower is not overcommitted. However in carrying out such an exercise buy to let loans should be left out of account where they are already serviced by their own income and only rents net of costs should be included as part of any assessment of overall income. Overall debt services coverage is a relevant metric as part of prudent underwriting criteria but it is only one approach to cross check creditworthiness, but not, we consider it as being appropriate as the principle determining factor when deciding on ability to pay.

The consultation paper is very confusing about all of this and we feel that greater clarity is needed. In paragraph 1.5.1 it is stated:-

"...since evidence (within jurisdictions) still supports a metric such as DSC ratio as a meaningful predictor of loan performance the Committee proposes to require the assessment of the borrowers ability to pay (for example through the DSC ratio) as a key underwriting requirement."

DSC, at this stage, is simply cited as an example. However when one turns to paragraph 51 in appendix 1 it says *"Underwriting policies must define (a) metric(s) (such as the loans debt service coverage ratio) and specify its (their) corresponding relevant level to conduct such assessment"*. There is then reference in foot note 42 to the FSB principles of sound residential mortgage underwriting to which we will return in a moment. Paragraph 51 runs on *"underwriting policies must also be appropriate when the repayment of the mortgage loan depends materially on the cash flows generated by the property, including relevant metrics, such as an occupancy rate of the property. National supervisors may provide guidance with appropriate definitions and levels to set metrics in their jurisdictions"*.

Turning back to the FSB's Principles foot note 2 says that (inter alia) buy to let borrowing should generally be considered within the scope of these principles, but they might not apply to such borrowing the same way as they would to the bulk of mortgage lending (see paragraph 6). Paragraph 2 refers to *"reasonable debt service coverage"* so that this is clearly intended to be a key factor. This refers to there being a requirement for an overall assessment of the borrower's ability to pay and it clearly intended to be assessment of the overall income and indebtedness.

As we say, all of this is very confusing. The overriding principle in the case of buy to let lending should be the ability to repay the loan, focussing on the income/receipts from the property as the starting point along with the creditworthiness of the prospective borrower. The starting point must be the cash flows from the property because the fact is that these cash flows service the repayments and it is for the very reason that this subcategory exists in the first place.

Regrettably, when it comes to analysing the current wording this is confusing as to what are to be the relevant underwriting criteria. The second sentence in paragraph 51 appears to apply to all real estate loans especially when you look back to 42 to the FSB principles and its own foot note 2. However, the third sentence, which is specific for buy to let lending refers to “relevant metrics”. The final sentence, however, seems to be a general application to all real estate mortgage loans. Buy to let loans are different to owner occupier loans according to the consultation and there is a fundamental distinction between the two so there needs to be a different approach between the two when it comes to the appropriate underwriting criteria. It is also important, in our view that discretion is left to local regulators to set the criteria.

Our suggested approach to any such ability to pay/credit worthiness assessment should be using rental income, typical rentable levels and demand for rental property within the locality of the property in question. Letting costs, and likely rent arrears should also be considered. Consideration should be given to other income and overall, in terms of credit worthiness, the overall financial position both in terms of income and indebtedness (in effect, the debt service coverage element) could then be looked at, but subject to the qualifications regarding treatment of buy to let debt and rental income which we have already mentioned.

On a separate note there is reference to the occupancy rate of the property being the relevant metric but it is not clear what is meant by this requirement. This need clarification as to what is in the mind of the Committee in this regard.

Personal recourse

One factor which is not being considered among the underwriting criteria is the difference between those jurisdictions which allow for personal recourse to the borrower, such as in the United Kingdom and other jurisdictions which do not. Common sense dictates that if your own personal monies are on the line you are far less likely to “hand back the keys” and the situation where there is no personal recourse. This issue does not seem to have been addressed by the Committee.

Adverse impacts on the UK private rented sector

We have already addressed this issue, to some extent earlier on in this response. The danger is that one can become too risk adverse. We appreciate the need to strengthen bank stability but overreaction also leads to bad decision making.

Worryingly, there are already signs in the UK that the parallel regulations effecting owner occupiers emanating from international interventions have had adverse consequences on the housing market. This is as a result of the actions of the Financial Stability Board as a consequence of their Principles of mortgage lending, to which we have already referred. Signs are emerging of these having serious unnecessary consequences for borrowers. Reports were appearing in the press that it is becoming more and more difficult for prospective owner occupier borrowers to obtain a loan. There are undesirable side effects. These include reports that it has become more difficult for those in their early 40s and later to obtain mortgages. They are being refused because of concerns that they are not going to be able to repay loans in time before retirement despite there being no legal retirement age and people working longer. This is very worrying because equally statistics demonstrate that due to the UK housing supply crisis, first time buyers are buying at a later age. The age of 39 has been reported as the average age for first time borrowers. Another consequence is that owner occupiers are being locked into their existing properties. They cannot trade up by acquiring a new home where they currently live. These kind of issues are impacting on the demand side of the equation. If owner occupiers cannot sell and trade up then it makes it more difficult for first time buyers, in particular, to acquire homes.

The stricter underwriting criteria and higher ratings weightings based on loan to value ratios, will have a similar impact on the buy to let market. As we have already pointed out, this will be at a time where we have the supply crisis in the UK with rising demand making it harder for landlords and prospective landlords to borrow.

Increasing the cost of that borrowing due to the measures being proposed requiring additional capital, will inhibit the provision of much needed new private rental accommodation to meet this growing demand. All this has another knock on consequence. Younger people are having to stay longer in private rental housing in

order to save up a deposit to put down for house purchase. If rental levels escalate because of increased cost of borrowing, then it becomes even harder for these hard pressed young people to be able to save up the requisite deposit.

Real estate advisors Savills have predicted that demand for rental housing in the UK will rise by more than 1 million households over the next five years. They predict that the private rented sector will grow by 1.1 million households by 2021 and this is on the assumption that the Government meets its target of building 400,000 new affordable homes for sale by 2020. They comment that house price inflation ahead of wage growth will serve to push home ownership further out of the reach of many with the stock in the social housing sector having shrunk by 2.8% in the past five years.

The English Housing Survey published by the UK Government show that private renting has been growing by 17,500 households per month on average over 10 years to 2014. This demonstrates why the actions proposed by the Basel Committee can have profound consequences in social and economic terms in relation to the housing market.

The Basel Committee and National Regulators

Whilst it is the role of the Basel Committee to deal with issues around bank stability, the market conditions differ from jurisdiction. A particular characteristic of the UK market is the large number of small landlord often only owning one property. National regulators are obviously more aware of local conditions.

Different points are reached at any particular time in local market cycles, and local regulation has a profound effect in different jurisdictions in different ways. We accept that banks, particularly the larger international banks, operate across these jurisdictions. However, in the case of buy to let lending, we are dealing with relatively small niche markets mainly focussed on certain counties such as the UK Ireland and New Zealand which share some common features. Therefore that this is a strong factor why the Basel Committee should exercise minimal interference leaving it to local regulators and supervisors to exercise more localised control in the light of prevailing local conditions.

Conclusion

In conclusion, we accept the relevance of loan to value ratios in deciding on international risk weightings under the standardised approach but consider that these should be as granular in the case of buy to let lending as is proposed for owner occupier lending. The proposed weightings to be assigned to buy to let are excessive and out of kilter with what is suggested in relation to owner occupation. They do not reflect actual loan performance according to the evidence especially when one looks at the relative weightings proposed by the Committee,

The Committee needs to lay down an appropriate approach to the assessment of ability of the borrower to pay and credit worthiness concentrating on cash flow from the property itself, getting away from over emphasis on debt service coverage which is not relevant where the primary criteria is the income/cash flows from the property in the case of residential buy to let lending.

The Committee to be very mindful of its impacts, particularly in relation to the cost and availability of borrowing. Greater regard needs to be had to the impact of local conditions. Overall, in our view, as representative body for landlords, whilst we acknowledge the need for ensuring banks stability at the same time, these specific proposals relevant to buy to let mortgage need to be thoroughly reappraised and re-stated.

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