

27 March 2015

Bank for International Settlements
Centralbahnplatz 2
4051 Basel
Switzerland

Dear Sir/Madam,

Basel Committee on Banking Supervision: Consultative Document: Revisions to the Standardised Approach for credit risk

Overview

Westpac Group appreciates the opportunity to comment on the Consultative Document (CD) "Revisions to the Standardised Approach for credit risk". Westpac, with A\$771b¹ in assets, covers a portfolio of financial services brands and businesses servicing nearly 13 million customers in Australia and New Zealand. Residential mortgages comprise a large portion of the Westpac portfolio, and through this the Group has built up a wealth of knowledge in measuring and managing residential mortgage risk, including the research of the primary risk drivers and relative risk sensitivities of residential mortgage portfolios. This memorandum proposes refinements to the residential mortgage risk weights proposed in paragraph 38 of the CD.

The main areas of concern for Westpac include:

- The combined risk drivers (current LTV² ratio and DSC³) are not the most predictive risk drivers, and are hard to implement consistently;
- The two factor matrix approach applied to all banks globally, doesn't reflect jurisdictional differences in the residential property markets, where clear differences in legal structure, nature of the lending and structural tax differences shape the risk of the loan portfolio; and
- There is not enough granularity in risk differentiation across the matrix with just a four-fold increase in risk between the best and worst categories.

An alternative approach is proposed, that will be more risk sensitive, easier for banks (large and small) to consistently implement, addresses regional and portfolio concentration differences, and provide an incentive for better quality mortgage lending portfolios.

The main proposed changes include:

- Replace the BCBS proposed risk drivers with Origination LTV and Account Utilisation;
- Introduce a high and low 'scaling' factor to address regional/jurisdictional differences; and
- Steepen the calibration for more risk differentiation to encourage good quality (i.e. low LTV and low utilisation) loans.

We note that different jurisdictions have different residential mortgage risk drivers depending on local product, taxation and regulatory characteristic. This makes the identification of risk drivers that apply globally challenging. In Australia analysis of Westpac loss experience indicates that account utilisation combined with origination LTV would be the best combination of risk drivers.

¹ As at September 2014.

² Current loan-to-value (LTV) is the total current amount of the loan divided by the value of the property at origination.

³ Debt service cover (DSC) ratio is the ratio of debt service payments (including principle and interest) relative to borrowers total income over a given period.

However, this may not be the case in other jurisdictions, where account utilisation may not be a good differentiator of default rates. This serves to highlight that imposing a two factor matrix, without allowing any jurisdictional considerations, would not be an appropriate approach for the assignment of residential mortgage risk weights.

Current proposed residential mortgage risk drivers

Current LTV ratio: While the current LTV is a good risk driver for the portfolio (particular for estimating the loss given default), there are challenges in sourcing this data consistently globally, particularly in markets where top-ups and multiple facilities (e.g. a combination of fixed and floating mortgages) exist.

Debt Service Cover (DSC) ratio: While the ability of a mortgagee to service their loan is intuitively important for reflecting the risk of non-payment, there are numerous challenges in calculating the DSC. These include obtaining accurate income data, determining which components of income to include and obtaining accurate measures of customer's liabilities given differences in privacy laws and availability of relevant credit bureau data. The risk sensitivity of the measure is also diluted by the fact that banks may treat DSC as a "hurdle" and only require demonstration of the minimum income required to satisfy the loan approval criteria and not require customers to disclose additional income that is not required to secure loan approval. Given these challenges, DSC is typically not found to be predictive of default risk or loss given default, as shown in Appendix 1.

Table 1: BCBS proposed residential mortgage risk weights

	LTV < 40%	40% ≤ LTV < 60%	60% ≤ LTV < 80%	80% ≤ LTV < 90%	90% ≤ LTV < 100%	LTV ≥ 100%
Loans to individuals with [DSC ≤ 35%]	25%	30%	40%	50%	60%	80%
Other loans	30%	40%	50%	70%	80%	100%

The proposed matrix has very little risk sensitivity with only a 4 fold increase in risk from the best to worst risk weight (i.e. from 25% to 100%) which does not adequately reflect the relative risk associated with a loan in negative equity (LTV>100%) compared to one with LTV below 40%, which can withstand a 60% fall in property prices.

Clarity on the type of portfolio the standardised risk weights are intended for

The BCBS should provide clear guidance as to whether the standardised risk weights are designed for highly diversified portfolios and that local regulators should consider additional Pillar 2 requirements where a bank's portfolio exhibits concentration risk relative to the standardised benchmark portfolio. We believe this is essential in order to establish the correct relationship with advanced risk weights, as proposed in the "Capital floors based on standardised approaches" CD.

Alternatives to the proposed residential mortgage risk drivers

Based on an analysis of the risk drivers in Westpac's portfolio, we propose an alternative set of risk drivers. This proposal eliminates DSC, which our analysis shows to be less predictive than intuition would suggest, while retaining a two factor approach. This alternative approach would involve:

- replacing current LTV ratio with the Origination LTV ratio, which:
 - is a simple calculation and not susceptible to different interpretations and calculation methodologies by region; and
 - is the most predictive driver of loss given default for residential mortgages.
- replacing DSC with loan Utilisation⁴, which:
 - is a simple calculation and not susceptible to different interpretations and calculation methodologies by region;
 - has been proven to be a highly predictive driver of probability of default in Australia as shown in Appendix 1 where the default risk increases sharply as a function of utilisation;
 - is intuitive as it indicates both the ability of a borrower to repay, and the propensity to repay. The measure will also be dynamic through time whereas DSC is point in time;
 - current Utilisation of the loan is a better representation of the amount of prepayment than the current LTV. For example, a loan starting with a utilisation of 90% and prepaying to 70% (evidencing the financial strength of the borrower) is typically a lower risk than a loan originated at 70% with no prepayments.

⁴ The amount of the current loan balance relative to the facility credit limit.

- Both factors can be derived from data captured and stored internally by all mortgage lenders, including those with foundation level credit risk data management capabilities and those in jurisdictions with strict privacy laws (negative credit bureau reporting).
- Will provide for increased ability to calibrate the matrix to allow increased risk sensitivity and discrimination of losses compared to the current proposal.

Note that the combination of origination LTV and Utilisation provides similar information to Current LTV, but has the advantage of more clearly separating the loss given default driver (LTV) and the probability of default driver (Utilisation). In Australia, Utilisation is an indicator of financial strength and is highly predictive of borrower risk. It has the further advantage of being a dynamic measure, unlike DSC which only reflects a borrower's circumstance at the time of origination.

It should be noted that difference in mortgage products, taxation and other legislation across jurisdictions may mean that these risk factors may not be predictive in other countries, where other drivers, not relevant to Australia, are more relevant. This highlights the importance of incorporating jurisdiction into the Standardised Approach.

Introducing a jurisdiction based scaling factor

We believe that the standardised approach needs to reflect differences in risk profile of different housing markets in order to have an appropriate degree of risk sensitivity. To address this, a jurisdiction category that increases/decreases the risk weight commensurate with the underlying regional risk needs to be introduced.

The determination of whether a country is high or low would consider (among other things) presence of Lender's Mortgage Insurance or government guarantees, incentives (including tax) underpinning house prices or encouraging early repayment of loans, and the historic regional volatility of the housing market. All factors would be objective, address the structural differences of markets and be applicable to all regions. In a similar fashion to the classification of specialised lending slotting criteria, the jurisdictional rating criteria could be clearly defined by the BCBS. National supervisors would then determine the appropriate classification of their own jurisdiction and this would be subject to review through the Regulatory Consistency Assessment Program (RCAP).

Conclusion

The specific recommendations we are making that would ensure a consistent, risk sensitive approach for determining residential mortgage risk weights are summarised below:

1. In order to calibrate revised Standardised risk weights for mortgage portfolios, it is essential to first specify whether they are intended to reflect the risk of a highly diversified portfolio or to provide minimum risk weights for any bank globally and therefore reflect more concentrated portfolios.
2. The risk drivers for residential mortgages need to be readily available and consistently defined globally, represent the main risk drivers, being probability of default and loss given default and predictive of risk.
3. There are large differences in the risk characteristics of residential mortgages across regions, which need to be taken into consideration in assigning risk weights. This may necessitate providing national discretion to implement different risk drivers in different jurisdictions.
4. The chosen risk weight matrix needs to be risk sensitive enough such that there is good differentiation between the good and bad quality exposures.

Appendix 2 provides an indicative example matrix of risk weights that illustrates how these recommendations might work out for the standardised approach for residential mortgages.

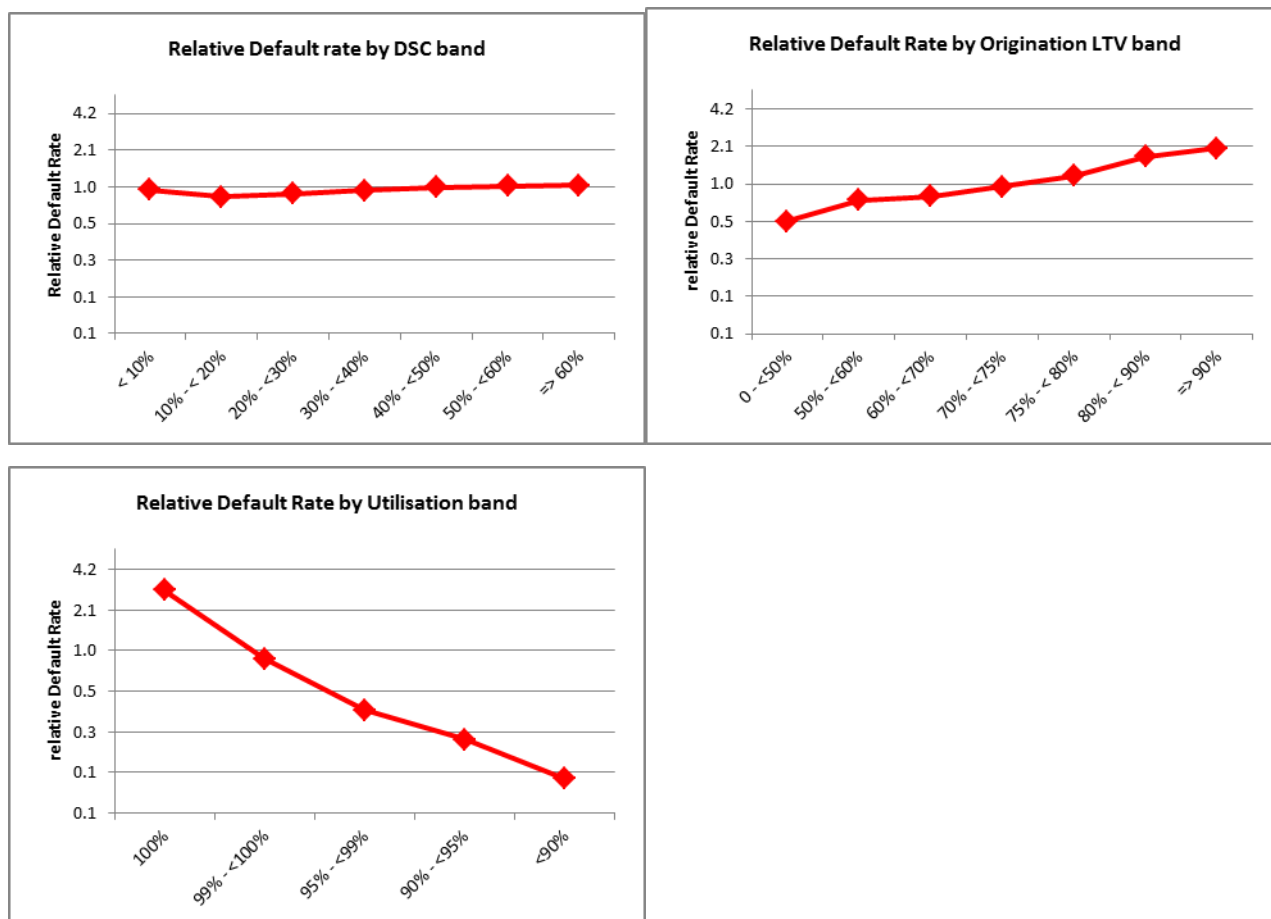
Yours faithfully,



Philip Coffey
Deputy CEO
The Westpac Group

APPENDIX 1:

The charts below show the ratio of the default rate in each category to the total portfolio default rate over a long run average (>10 years), for example a relative default rate of two, is double the long run average default rate. The analysis highlights that Utilisation discriminates between high and low default rates well, as does origination LTV. DSC is not a good discriminator of default rates with a consistent relative default rate regardless of the DSC band selected.



APPENDIX 2:

The illustrative matrix has been calibrated to the current standardised approach 35% risk weight, with the relative risk weights then determined for the rest of the matrix based on an analysis of Westpac data, and is shown as an example of how the matrix could be populated. These risk weights would be applied by all banks globally and while capturing the most important risk drivers, would also ensure there remains risk sensitivity in the calculating of risk weights to encourage better quality mortgage portfolios than the current proposed approach shown in Table 1.

Table 2: proposed residential mortgage risk weights.

	Jurisdictional risk:			
	High		Low	
	Utilisation $\geq$ 95% ⁵	Utilization < 95% ⁶	Utilisation $\geq$ 95%	Utilization < 95%
LTV $\geq$ 90%	70%	50%	60%	40%
80% $\leq$ LTV < 90%	35%	25%	25%	15%
60% $\leq$ LTV < 80%	25%	10%	15%	5%
LTV < 60%	10%	5%	5%	5%

Notes for the table:

- Table 2 is based off a benchmark risk weight of 35% (selected to align with the current standardised approach risk weight for residential mortgages) for a combination of LTV between 60% and 80%, and the utilisation $\geq$ 95%. The risk weights for the remainder of the matrix are then based on relative risk contribution as determined by analysis of Westpac internal data. A conservative LGD buffer (10% floor) was also applied to low LTV segments, increasing low LTV relative risk weights above those based on empirical data and stress scenarios alone.
- The difference between low and high jurisdictional risk in table 2 is illustrative and can be calibrated separately, and in this case is assumed to represent a 10% risk weight difference (i.e. from the 35% benchmark down to 25%). Furthermore, and a 5% risk weight floor has been applied.
- Account utilisation buckets were chosen that provide even distribution from Westpac data, where half are on schedule ($<5\%$ ahead of schedule), and half were ahead of schedule at ($>5\%$ ahead of schedule). In addition, there were found to be significant differences in performance between these two groupings.
- Some of the risk segments cover wide ranges of the risk drivers and risk weights have been calibrated to allow for exposures at the higher risk end of each segment.

⁵ The customer is less than or equal to being 5% ahead of schedule.

⁶ Or the customer is greater than 5% ahead of schedule.