



YBS' RESPONSE TO THE BASEL COMMITTEE ON BANKING SUPERVISION'S (BCBS) SECOND CONSULTATIVE DOCUMENT ON THE REVISIONS TO THE STANDARDISED APPROACH FOR CREDIT RISK

Yorkshire Building Society (YBS) welcomes the opportunity given to stakeholders by the Basel Committee to comment on the second consultation paper on the Revisions to the Standardised Approach for credit risk.

YBS is owned and governed by its members and is Britain's second biggest building society with 3.1 million customers. In 2015, the Society grew total assets to a record £38.2bn, achieved a Common Equity Tier 1 capital ratio of 14.5% and leverage ratio of 5%. YBS currently operates under the Standardised Approach.

YBS is a member of the Building Societies Association, and supports both their response as well as that of the European Association of Co-operative Banks. YBS wishes to take this opportunity to express its views on this topic, given the impact it has on our firm and the building society sector as a whole.

Introduction

- The lack of enduring indexation creates pro-cyclical risk (current, capital requirements would rise as house prices fall).
- Lack of indexation implies that a First Time Buyer will be motivated to take a short term deal and then look to refinance to another lender once they have built some equity up thus creating a riskier position for themselves (e.g. having a shorter term fixed gives security of payments for a shorter time) and unnecessary churn in the market place.
- Diversity in financial services will suffer due to the differential impact of the proposed approach.
- The wording on residential real estate exposures where 'repayment is materially dependent on cash flows generated by the property' potentially captures low risk lending portfolios that do not exhibit the level of defaults that the proposed risk weights would imply; this wording should be reviewed.

Curtailing indexation

- Definition of 'origination' as occurring when new mortgages are added to the loan book rather than when the Loan to Value (LTV) ratio 'resets' at certain periods (such as at the end of a fixed interest term), will make borrowing money to buy a home harder.
- The Basel Committee is considering requiring the value of the property to be kept constant at the value calculated at origination. Thus, the LTV ratio would be updated only as the loan balance (i.e. the numerator) changes. Since there is no allowance for indexation, YBS strongly believes this lack of indexation will force first-time buyers to take short term deals which will bring them into a riskier position in terms of potential interest rate exposure than they would have been otherwise.

- YBS recognises that the intention of the proposal is to remove the impact of property price bubbles (which could lower capital requirements by reducing LTV) but strongly believes that this risk is mitigated by existing provisions. Firstly, the Countercyclical Capital Buffer will force firms to build up capital in times of bubbles and release it in a crash, therefore achieving the objective of countering such a bubble. Secondly, Pillar 2B stress testing (and other regulatory stress tests carried out in jurisdictions) incorporate the impact of an economic downturn, with more severe property price crashes applied after times of rapid property price increases.
- Given that existing elements of the capital framework mitigate the risk of property price bubbles, YBS believes that the BCBS should continue to recognise indexation in property prices. In an ordered market property price increases would still be expected in the medium to long term, even if simply due to general consumer price inflation and nominal wage growth. To ignore this removes a key indicator of risk from the capital calculations and therefore weakens them; while creating a position where the capital required against loans is no longer linked to their risk. To illustrate the latter point, a loan advanced during a property bubble could appear low risk while a more seasoned loan that has seen many years of genuine HPI increases could appear higher risk.
- The translation of the proposed non-indexation of property values will have clear implications for pricing of mortgages, with borrowers therefore incentivised to move their loan to an alternative lender once it has become sufficiently seasoned as to benefit from a lower LTV treatment. This seems likely to introduce an unhealthy element of “churn” into the market place which may produce systemic risks to the market as a whole and additional costs in terms of customer acquisition. These competition effects seem likely to have the potential for greatest negative impact on smaller players (with less distribution and origination capability), thereby further reducing diversity in the market place.

Impact on First Time Buyers

- Higher LTV ratios and lack of indexation will force FTBs, who typically have smaller initial deposits, in order to get onto the ladder at all, to take short term deals. These will still be more expensive than at present due to the inability to take any indexation projections into account at point of origination. They will then need to refinance to another building society or bank as soon as possible to benefit from a rate which reflects the impact of HPI on their property.
- The proposals risk penalising certain groups of borrowers, in particular younger borrowers attempting to purchase their first home, who will tend to borrow at higher LTV and whose debt servicing will likely be a higher proportion of income as a result of artificially high capital requirements.
- These future homebuyers’ reliance on shorter fixed term deals will increase this group of customer’s exposure to interest rate increases.

Financial Services Sector Diversity

- Market response will be further growth of securitisation which will allow arbitrage as those investors outside the regime entirely, such as hedge funds, will be able to reflect the assets

real economic risk. For large PLC banks this may allow them to escape the provisions entirely.

- Building societies, due to nature limits, must rely on retail deposits for at least half of funding. Smaller societies, who have no access to wholesale markets, will be worst hit.
- Promoting diversity is now a requirement on the UK Prudential Regulation Authority, as is the principle of proportionality in EU law, making BCBS proposals inconsistent with the wider post-crisis banking regulatory framework across Europe.

Buy to Let definition

- The proposals include higher capital requirements for loans where ‘repayment is materially dependent on cash flows generated by the property’ and YBS believes that the definition is too wide. This could capture a range of lending from low risk Buy-to-Let (BTL) and interest only lending, to high risk equity release mortgages. It would be beneficial to review the wording to capture lending that is genuinely higher risk while excluding items such as BTL that have demonstrated lower loss levels over time. To the extent that these type of loans exhibit slightly higher risk than other residential mortgages, this can continue to be captured under Pillar 2.
- The historically used risk weights have been more than adequate for losses over long term in UK market, as Andrew Bailey agrees in case of BTL looking forward as well; “while we don't observe a problem - if you look at arrears rates, for instance - we don't observe a problem ...”¹
- Definition of Buy to Let is too widely defined at present to include all interest only mortgages, apart from where the lender could be convinced beyond any doubt that the borrower has a repayment vehicle in place. The onerous checks forced by this would put an unnecessary barrier upon customers.
- The overall increase in risk weights for the whole sector will be disadvantageous to the supply of rented housing in several jurisdictions, such as the UK and the Netherlands. The fundamentals of the UK housing mortgage, with low supply and high comfortable mortgage affordability, continue to drive good BTL performance. The proposals fail to recognise the actual levels of risk involved.

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¹ Andrew Bailey: Financial Stability Report press release, December 2015