



**YBS  
GROUP**

## **YBS' RESPONSE TO THE BASEL COMMITTEE ON BANKING SUPERVISION'S CONSULTATION 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 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 3.3 million customers. In 2014, the Society grew total assets to a record £37.6bn, increased liquid balances to £4.8bn, comfortably above regulatory requirements and achieved a Common Equity Tier 1 capital ratio of 13.8% and leverage ratio of 4.8%

The UK trade body for building societies, the Building Societies Association (BSA) has committed itself to respond to the consultation paper. As a member of the BSA, YBS fully supports the BSA's submission and alongside generally that of the response from the European Association of Co-operative Banks, of which they are a member. Nevertheless YBS wishes to take this opportunity to express its views on this topic as well, given the impact it has on our firm and the building society sector as a whole.

### **Introduction**

- These proposals are fundamentally focused on problems in the United States (where mortgage loans are effectively unsecured obligations in many states). It is not appropriate for many EU jurisdictions, including UK, where Loan-to-Value (LTV) ratio's up to 95% are commonplace.
- Would imply substantially higher capital requirements for higher LTV loans, especially for standardised lenders (such as smaller building societies). Therefore will distort the Market even more (more concentration in the hands of the big Banks) and will hit First Time Buyers (FTB) the hardest.
- The lack of 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 (expensive) deal & 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) & unnecessary churn in the market place.
- The Debt Service Coverage Ratio (DCR) component is unworkable internationally - every country has different cultural, tax & social welfare arrangements.

YBS supports the overall objectives of the Basel Committee's revision exercise in that the review should keep the fundamental concept of the current framework. YBS also supports the Committee's stance on the standardised approach being simple and suitable for a wider range of banks, not just internationally active banks. Lastly, YBS agrees with the Committee that the policy recommendations should be justified by illustrating either the weaknesses or the potential correction of a misalignment.

However YBS remains concerned about the treatment of residential mortgages, social housing lending and Buy to Let lending, all of which the Society engages in within the UK financial services market.

As a general point, YBS suggests that the existing standardised approach is not in fact in need of significant redevelopment. The main weakness of the existing standardised method is its overestimation of risk on most residential mortgages; the proposals to increase most mortgage risk weightings therefore are a move in the wrong direction.

The review would imply **substantially higher capital costs** for higher loan-to-value mortgages because of the wider range of risk buckets and weightings, especially for standardised lenders (such as smaller building societies, which unlike ourselves could not decide to switch to IRB). YBS is sceptical about this increase in capital cost since it will drive price increases for borrowers and significantly reduce their loan availability. Moreover it will enhance concentration with large banks and will hit first-time buyers the hardest. It will also carry the danger of damaging the long term functioning of the UK housing market, undermining the traditional operating model where FTBs can move on, creating a disjuncture between those currently on and others locked out of the housing ladder.

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 (ie the numerator) changes. Since there is no allowance for indexation, YBS strongly believes this **lack of indexation** will create pro-cyclical risks in terms of capital requirements rising as house prices are falling and first-time buyers will be motivated to take short term (expensive) deals which will bring them into a risky position.

Lastly, YBS believes the **debt service coverage ratio** component used as a binary indicator of the likelihood of loan repayment is not a suitable instrument at international level, given the fact that every country has different cultural, tax & social welfare arrangements.

The Basel Committee also proposed to impose a **standardised approach floor** on modelled credit risk capital requirements in order to constrain variation in risk-weighted assets. YBS suggests it is highly questionable to weaken the robustness and proportionality of the standardised approach in an effort to repair perceived issues with IRB modelling approaches. Any weaknesses in IRB models should be addressed directly by regulators. The proposals risk the viability of smaller firms and challengers that do not have IRB capability and will reduce competition in key markets.

YBS is concerned about the plans to implement higher capital requirements for higher LTV loans, the lack of indexation and the use of the debt service coverage ratio since they would be detrimental to the business model of building societies. Obliging smaller banks to progress to IRB modelling, alongside the impact of these proposed reforms to IRB itself, will leave building societies in particular with a competitive disadvantage.

As a response to the Consultation paper questions itself, YBS's replies will only cover the topics which impact within its main ambit of relevant activities (residential mortgages, social housing lending and Buy to Let lending).



### Question 1

What are respondents' views on the selection of the capital adequacy ratio? In particular, is the CET1 ratio superior to the Tier 1 ratio or the Leverage ratio? Do respondents agree that it is necessary to require calculations in accordance with Basel III in order to ensure a consistent interpretation?

The CET1 ratio is a strong indicator of a bank's resiliency to risk and is therefore a reasonable element in assessing its creditworthiness. It is certainly a superior measure to the highly limited leverage ratio, which takes no account of the risks faced. The leverage ratio already penalises low risk business models and including it in these measures would further discriminate against firms that concentrate in low risk assets.

The main issue with the selection of the CET1 ratio, especially in combination with the NPA ratio, is that the measures will tend to be highly pro-cyclical.

### Question 2

Do respondents believe the net NPA ratio is an effective measure for distinguishing a bank exposure's credit risk? What alternative asset quality measure, if any, should be considered by the Committee?

See comment on pro-cyclicality under Q1.

### Question 3

Do respondents have views on the proposed treatment for short-term interbank claims?

More clarity is needed regarding the statement that 'claims with an original maturity of three months or less which are expected to be rolled over do not qualify for this preferential treatment'. Answers to the following questions is therefore sought; how to evidence whether claims are expected to be rolled over? What is the consequence if a claim is not expected to be rolled over but is subsequently rolled over? What about funds placed in current accounts or similar? The 30% floor to these risk weights is arbitrary. It is the Society's view that there should be some recognition for the lower risk of short term bank exposures even for stronger firms.

### Question 8

Do respondents agree that introducing the specialised lending category enhances the risk sensitivity of the standardised approach and its alignment with IRB?

The proposal, including the characteristics in paragraph 21 of Annex 1, risks applying penal risk weightings to certain lending categories, such as UK housing associations. The wording should be changed, either to specifically exclude such borrowers or to prevent capturing them within this definition.

### Question 10

Do respondents agree that LTV and/or DSCR ratios (as defined in Annex 1 paragraphs 40 and 41) have sufficient predictive power of loan default and/or loss incurred for exposures secured on residential real estate?

YBS believes that LTV and DSC/DTI ratios are a reliable predictor of loan default and/or loss incurred at the inception of the loan. However, the use of the debt service coverage is not realistic for older loans and potentially for smaller institutions. The application of this approach would lead to significant increase in capital requirements for back books where debt service coverage information may not be available, with a consequent impact on the availability of credit.

The application of a high debt service coverage ratio for loans that are not to individuals will also severely penalise the UK social housing sector through excessively high risk weights that would apply to this extremely low risk lending. This must be revisited to prevent a reduction in credit for this sector.

The absolute level of proposed risk weights is also a significant issue, with large increases in risk weighting compared to the existing European implementation. Not only would such increases in risk weighting reduce credit supply and increase pricing for customers, but it is not in line with the actual risk of assets. A recent consultation paper by the Bank of England Prudential Regulation Authority (CP1/15) implies that the existing standardised method overstates the risk weighting of residential mortgages at virtually every LTV level; applying significant increases in risk weights for mortgages is therefore counterintuitive.

The proposals also 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. The extremely high risk weights for higher LTV and higher DSC loans could price such borrowers out of the market.

DSC is also a limited tool in that it only considers debt. In the example of first time buyers quoted above, they may have a higher debt servicing coverage ratio than other borrowers, but may also have lower other costs, for example childcare. In effect, the proposals will tend to discriminate against younger customers in particular.

## Question 11

Do respondents have views about the measurement of the LTV and DSC ratios? (In particular, as regards keeping the value of the property constant as measured at origination in the calculation of the LTV ratio; and not updating the DSC ratio over time).

YBS suggests it is difficult to see the benefit of not updating these measures over time. While leaving these figures static can remove the impact of property price bubbles (albeit only for loans made prior to the bubble) and makes the standardised requirement less procyclical, there is a significant risk that the market may cease to have faith in firms' capital ratios during downturns. This is because the RWAs will be based on origination LTV levels that will seem inflated in a downturn that includes significant property price reductions. This could exacerbate any funding difficulties that firms may experience in such a scenario (particularly for firms with large residential mortgage portfolios on the standardised approach) as market participants may choose not to lend to/invest in counterparties if they believe the capital ratio to be incorrect. In summary, the Basel Committee may be unconcerned at the widespread considered opposition by firms across Europe of different scale and business model to these proposals, but it will be the judgement of financial markets as a result of these proposals if implemented that capital ratios are no longer relied upon by markets. The impact of this for global financial stability will be substantial.

The Basel Committee will need to reconsider the practical meaning to be used of 'origination' in this context. If this continues to be defined as only when a customer is new to the book, rather than when the LTV and DSC effectively 'reset' at certain periods, such as a change of product firms will be at a disadvantage to competitors when attempting to retain customers, as a customer who has seen improvements in LTV and DSC (which would be common over time) would appear lower risk to competitors who can use up-to-date measurements. If a firm is forced to price in higher capital requirements than its competitors due to using out-of-date measures, it will be placed at a disadvantage and have an incentive to shed those customers leading to huge and unprecedented levels of market 'churn'. The Society views the correct principle to be followed should be that borrowers remaining with their existing lender are treated consistently with those re-mortgaging at product maturity. YBS as a member owned organisation seeks to build a long term relationship with its mortgage borrowers, who also own the society. A change of the nature proposed by the Basel Committee would be at risk of substantially undermining the mutual model of UK building societies, and other stakeholder banks Europe wide and globally, where relationships with customers have more importance than under a shareholder ownership model.

Maintaining origination levels for DSC and property valuation will also lead to firms holding excessive capital levels against more seasoned loans, particularly those that remain with the lender through their lifetime. Property valuations and DSC/income levels could be out of date by decades, vastly reducing the accuracy of risk weightings. It would be entirely illogical for seasoned, and so less risky back books, to be subject to higher risk buckets just because the data is not available. Therefore YBS believes it would be better to apply the new rules to new loans and leave the back book at 35%.

## Question 12

Do respondents have views on whether the use of a fixed threshold for the DSC ratio is an appropriate way for differentiating risks and ensuring comparability across jurisdictions? If not, what reasonably simple alternatives or modifications would respondents propose while maintaining consistent outcomes?

The DSC is a limited tool, as noted in the response to Q11. In addition, there is likely to be a large crossover with the LTV measure; borrowers with lower LTVs are likely to have relatively lower debt servicing commitments than those with higher LTVs. It is therefore doubtful whether DSC adds a great deal of risk sensitivity to standardised requirements for residential mortgages.

A fixed threshold is less risk sensitive than a graded measure - indeed, the Basel Committee are proposing to move away from a simple threshold measure for LTV so it appears counterintuitive to apply a simple threshold to DSC.

Theoretically, a fixed threshold for a DSC ratio could only work if it were set at a constant rate, reviewed periodically according to the economic outlook of the sovereign state in which the loan/security is originated.

## Question 13

Do respondents propose any alternative/additional risk drivers for the Committee's consideration in order to improve the risk sensitivity in this approach without unduly increasing complexity?

The first consideration should be the proposed risk weightings. They are not more risk sensitive than the current standardised approach as the risk weights are almost all higher than the existing method, many considerably so. Given that the existing standardised method overstates mortgage risk, the proposals are not risk sensitive so much as simply less accurate. For instance, in the CP1/15 consultation in the UK the Bank of England Shadow IRB scenario suggests that a 3.3% level would be appropriate based on a Shadow IRB scenario, compared to the 35% currently applied to firms using the standardised model as it currently stands.

An increase to risk sensitivity would necessitate the reflection of the extremely low risk in low LTV lending (potentially with the combination of graded DSC) to apply significantly lower risk weights for those mortgages.

## Question 16

Do respondents agree that a risk weight add-on [ for currency mismatch] should be applied to only retail exposures and exposures secured by residential real estate? What are other options for addressing this risk in a simple manner?

YBS agrees that borrowers, permanently resident in one country borrowing in the currency of another should be subject to some form of additional capital weight. This need is highlighted by the recent examples of permanent residents of eastern European nations buying local property but financed in Swiss francs. However it is important to distinguish this undoubted risk from the case where expatriate borrowers buy property, where the security is located in their native country and the loan denominated in the currency of the native currency. While the currency of earning might well be different from the currency in which the loan is denominated, the nature of expatriate employment is more transient and often subject to more favourable tax regimes. As a result, in response to a currency mismatch stress, the borrower is better able [a] to afford to manage the risk and [b] return home to work in his/her native country and continue to service the loan.

In conclusion, there should be no add on for currency mismatch loans if [a] the mortgage security is in the nation of which the individual holds a passport [b] the currency of the loan is that of the country of which the individual holds a passport.