Basel Committee on Banking Standards Consultative Document on Revisions to the standardised approach for credit risk

**Response by the Council of Mortgage Lenders
to the Basel Committee on Banking Supervision Consultative Document**

Introduction

1.   The CML is the representative trade body for the residential mortgage lender industry that includes banks, building societies and specialist lenders. Our 125 members currently hold around 95% of the assets of the UK mortgage market. In addition to lending for home-ownership, the CML members also lend to support the social housing and private rental markets.

2.   We are grateful for the opportunity to respond to the Basel Committee on Banking Standards (Basel), consultative document on revisions to the Standardised Approach to credit risk. We are happy for our response to be shared between the regulators and for it to be made public.

3.   Our views on these proposals necessarily reflect our interest in their impact on mortgage lenders and the mortgage market. Some aspects of our response may also be applicable to the rest of the financial services industry.

Executive summary

4.   Any change in capital requirements has to balance the need to ensure financial stability with the need to allow markets to function and appropriate lending to take place, at an appropriate cost. We feel that the present proposals do not strike the right balance. In particular, we do not believe the proposals, as currently cast, reflect an accurate assessment of the risks entailed in real estate lending in the UK. We are concerned that the proposals, as designed, will have a series of both intended and unintended overly negative consequences for specific sectors of the mortgage market.

5.   There are three main areas of concern:

a)   The changes in risk weights proposed for residential lending, because of the introduction of a two-factor model, exaggerate the risk of this asset class. The imposition of higher risk weights would have a detrimental impact on the lending in the UK and would particularly affect first-time buyers who would be likely to be priced out of the housing market. We, therefore, favour maintenance of the current status quo on risk weights for residential lending.

We do not feel the proposed changes add sufficient detail to the risk calculation to out weigh the issues and complications the changes envisage. The two-factor model as described would not lead to an improved risk calculation reflecting the economic risk of UK residential mortgages. In particular, the use of a debt service coverage ratio (DSC) as outlined in the paper is not an effective risk indicator in the UK. We would favour a locally calibrated approach and a focus on the LTV ratio, which we believe, is the best indicator of potential default and loss. Further work needs to be undertaken, in conjunction with the industry, before a more risk sensitive model could be introduced effectively. This work would include both the identification of the most appropriate risk factors but also the definition of these risk factors.

b)   Buy-to-let lending should be treated as a retail residential real estate exposure (this treatment is consistent with the existing regulatory framework, in particular the Capital Requirements Regulation (CRR)). This would seem a sensible categorisation given the scale of the BTL market, its particular place in the housing eco-system and that the collateral is the same. We would note that the two-factor model proposed for residential real estate lending would not be appropriate, however, for BTL. We would propose a risk weighting to reflect the evidence of the riskiness of lending to this particular sector and in

line with the risk-weight similar residential real estate collateral is given. Based on UK data, this would result in a significantly lower risk weighting than suggested in the paper. The proposed weighting would have the effect of significantly reducing lending to this sector (and/or raising the costs considerably), even though there is no evidence of additional default and risk. This would damage the availability of property for rent in the UK and could produce a significant reduction in available rental accommodation, with obvious and adverse social consequences.

c) An apparent unintended consequence of the proposals would be a higher risk weights on lending to social housing associations. This would significantly reduce lending to the sector and raise costs that would substantially reduce the availability of social housing in the UK with serious implications for those individuals needing low cost housing. As there is no evidence to suggest that this higher risk categorisation is justifiable, we cannot believe that this was intended.

General comments on methodology

6.   We agree that a loan-to value (LTV) ratio is a relatively good indicator of potential loss or default on a global basis (subject to the comments below), but we do not agree the same can be said for debt service coverage ratio (DSC). This is because of significant differences in national economies, such as tax regimes and the ability to set mortgage interest payments against tax.

Evidence base for assessment of market risk

7.   Any change in risk weights should be based on clear evidence that a specific asset class carries greater risk. Our data suggests that default rates of both residential and buy-to-let (BTL) mortgages are extremely low and do not justify a change of risk weights. Furthermore, as outlined below, the incidence of default in the social housing market (paragraph 24) is such as to support our view that risk weights for this asset class are too high and that any increase is unjustified.
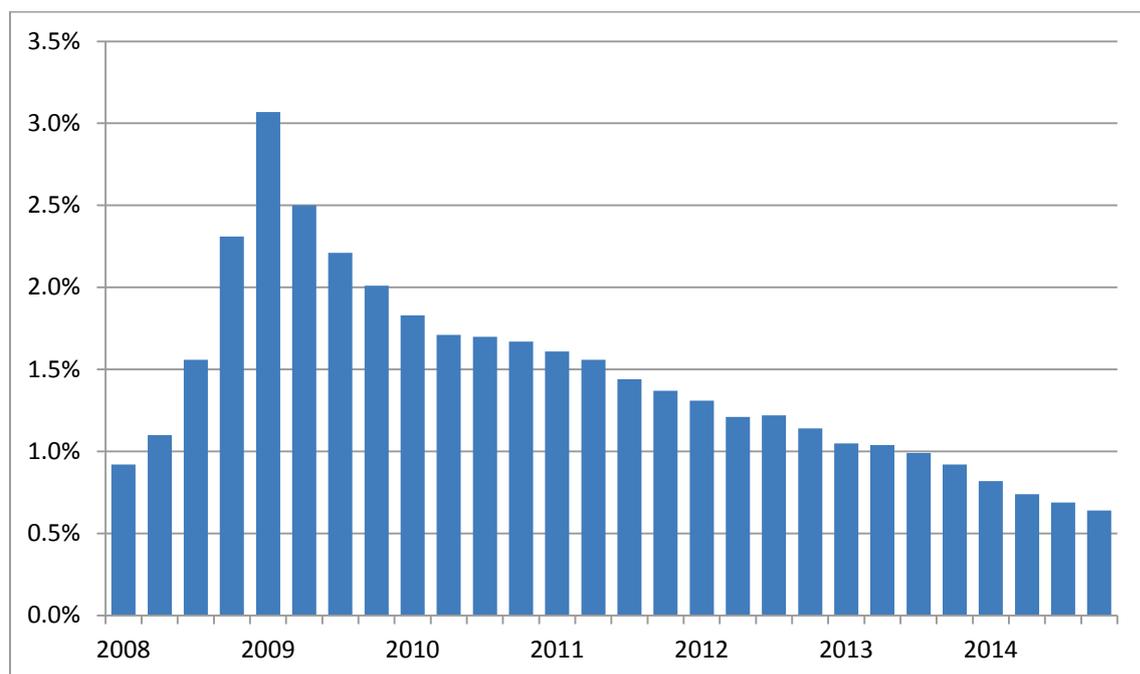
8.   Below we detail data for arrears for both residential mortgages and BTL mortgages:

All mortgages more than three months in arrears as a proportion of total mortgages outstanding (Half Year Data, Source CML)
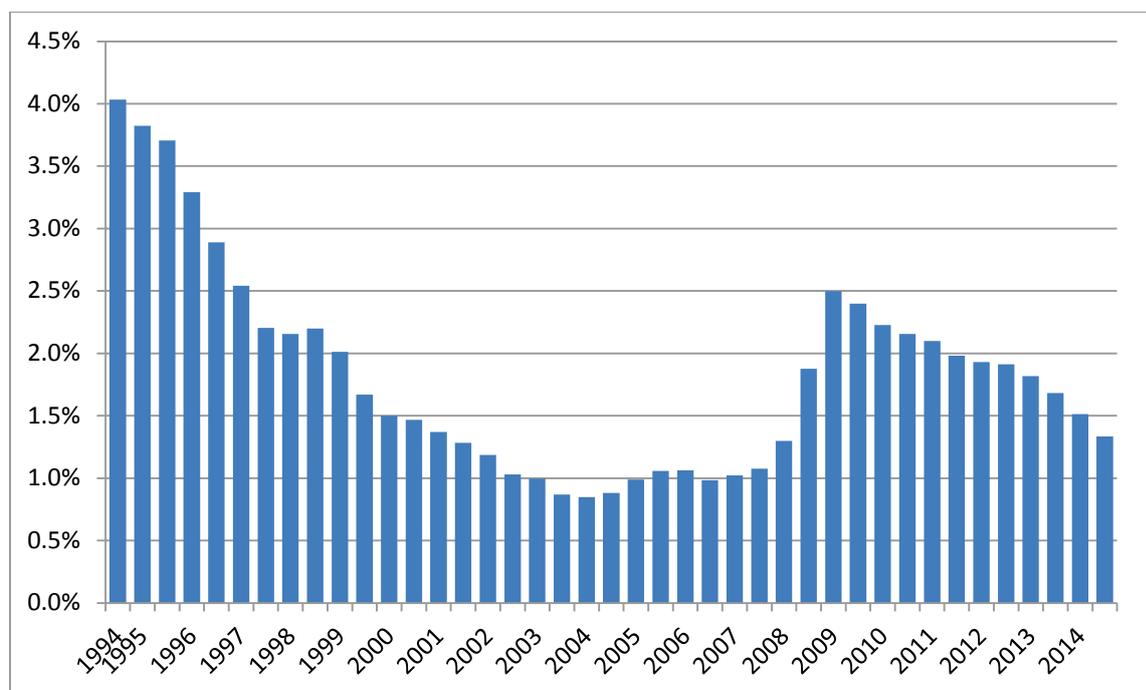
(Half Year Data, Source CML)

Buy-to-let mortgages more than three months in arrears as a proportion of total buy-to-let mortgages

(Quarterly Data, Source CML)

9.   Both graphs indicate that arrears at relatively low levels, at that over the course of an economic cycle, do not indicate a significant change in the risk profile of these assets that could justify a change in the risk weights.

10.   The current risk weights represent a relatively simple view of the risks of the various asset classes. However, even a small change in this approach opens up a number of issues for lenders in different jurisdictions, reflecting the national idiosyncrasies of mortgage markets. Any attempt to create a slightly more sophisticated risk-based model (but short of IRB) risks falling between two stools, namely not being sophisticated enough to reflect the true risks but at the same time bringing an additional layer of regulation resulting in a number of unintended consequences and market inefficiencies.

11.   Given this inherent conflict between objectives and the operation of national mortgage markets, we feel that some degree of national regulatory interpretation is necessary to provide national context to the regulation.

Proportionality

12.   International and national regulators have undertaken various initiatives to address the issues that contributed to the financial crisis and improve the robustness of the financial system. Any changes to the standardised risk weight approach should take into account the changes in the regulation of the sector. We do not feel that the proposals outlined in the paper fully take account of the substantial changes that the banking industry, and more specifically the mortgage sector, has undergone since the crisis. This includes:

   a) enhanced micro-prudential supervision and calibration of capital held;

   b) macro-prudential regulation to ensure sufficient capital is held to absorb losses; and

   c) improved conduct regulation, all of which ensure that firms' appetite for excessive risk is curtailed.

All of which ensures that firms' appetite for excessive risk is reined in.

13.   Both the Mortgage Market Review in the UK and the EU Mortgage Credit Directive have made significant changes to the way the mortgage industry originates business including, in particular, the requirement to carry out stressed affordability checks at origination. The affordability test has introduced an additional layer of assessment into the lending process that is likely to reduce the probability of future loss. No changes to the risk-based capital system should be introduced until evidence of how these changes have altered the risk profile of mortgages can be assessed.

14.   Much of the macro-prudential regulation in the UK has had a direct impact on the mortgage business including, for example, the imposition of Loan to Income (LTI) lending caps and the Leverage Ratio. Again, we suggest that this approach addresses the issue of perceived risky lending without the complications raised by changes in the risk weights.

15.   We believe that the proposed changes would result in lenders having significantly increased capital requirements. This contrasts with the results of the recent capital stress tests conducted by the Bank of England, which concluded that, although some banks needed to raise capital, the banking system was largely well capitalised.

16.   We also highlight the changes in the risk-based capital calculations that have already been introduced. Lenders at a national level may have to hold additional capital via a counter-cyclical buffer and national regulators have the discretion to impose sectoral capital requirements, on mortgage books, for example, if excessive risks are detected. Global Systemically Important Banks (G-SIB's) will also have additional capital requirements under the creation of Total Loss Absorbency Capacity (TLAC). We believe that regulators have sufficient tools at their disposal to ensure that lenders hold adequate capital for the balance sheet risks they have.

17.   The risk-based capital regulatory methodology and framework, therefore, should be seen as part of the overall regulatory system: additional risk-based capital buckets have been created, and which now also encompasses a non-risk-based element specifically designed to address some of the failings of the previous risk-based system. Any changes in the risk-based composition of the structure, therefore, have to be seen in light of the additional regulatory framework created and how overall, the banking industry now operates.

Specific comments on different asset classes

Exposures to Corporates (Section 2.2 and specifically 2.2.2 on specialised lending)

Social Housing

18.   In the UK, there is a large social housing market where lenders provide financing to corporate entities that in turn provide individuals access to various forms of residential property, including social housing. This sector plays an important social and economic role that extends far beyond the housing market. Yet it is unclear where certain of its assets would fall within the classification used.

19.   Within the UK, the structure of the social housing sector varies across devolved governments. Thus, within Wales, the sector is regulated by the Welsh Government and, therefore, lending to the sector, could be defined as lending to public sector entities (PSE). However, in England a separate body, the Housing and Communities Agency (HCA) acts as the regulator. This difference in legal regulatory structure emphasises the subtle differences within mortgage markets and highlights how any change in risk-weights opens up considerable difficulties.

20.   The problem arises from section nine of the document (paragraph 36), which defines a residential real estate exposure as:

> "*an exposure secured by a mortgage on a residential property providing that it does not meet the criteria to be considered as specialised lending as defined in paragraph 21. Moreover, the risk of the loan repayment must not be materially dependent upon the performance of, or income generated by the property securing the mortgage but rather on the underlying capacity of the borrower to repay debt from other sources*".

21.   While the social housing sector contains a number of different types of entities, a significant number demonstrate the characteristics outlined in paragraph 21, to be classified as specialist lending

(highlighting the requirements that such characteristics need to be present in legal or economic substance). In particular, smaller social housing associations would be not be able to demonstrate other income sources to repay debt and would, therefore, probably fall within the classification of specialised lending.

22.   If this were the correct interpretation of the document, this would indicate an increase in the risk-weight from 35% to 120%. Alternatively, it could be that social housing could be classified as "other corporate" or as "other retail". However, under both definitions the risk-weight would also significantly increase.

23.   We emphasis that the evidence of default and loss over a forty-year period - through a number of economic cycles - does not support an increase of the risk-weight. In fact, the evidence of no default in this sector over this time would support the contention that a lower risk weight than 35% would be appropriate.

24.   In support of this, we point to the performance of the Bank of Scotland plc social housing covered bond programme as further evidence of the strength of the social housing asset class. Notwithstanding the difficulties the originator of the loans faced in the financial crisis, the covered bonds continued to be serviced and no defaults have been registered in the cover pool. Likewise, the experience of the Housing Finance Corporation (THFC), a specialist not-for-profit organisation that makes loans to regulated housing associations supports this assertion: THFC records that there has been no default in this sector that has resulted in loss for lenders or investors.

25.   Changing the risk-weight for the social housing asset class would have considerable impact on the market in this area. In consultation with our members, we estimate that the change in risk-weight could raise the interest rate charged on such assets by 1%. It would also be likely that, as a corollary of this, a number of lenders and housing associations would withdraw from this market. This would result in higher costs and reduced availability of finance for an important social asset class.

26.   We should note that not all housing associations would be affected in the same way (which indicates the intrinsic unfairness of the approach). The criteria "…the primary source of repayment of the obligation is the income generated by the asset(s) rather than the independent capacity of a broader commercial enterprise", might offer some, large, social housing entities a route to be exempt from classification as specialised lending, but even this this would need further clarification.

Q8. Do respondents agree that introducing the specialised lending category enhances the risk sensitivity of the standardised approach and its alignment with IRB?

While we understand the approach of introducing a specialised lending category, we feel that the approach does not go far enough. The consultation paper recognises the granularity of corporate lending and to advance the risk sensitivity of the standardised approach we feel a number of additional sub categories of asset class need to be introduced to reflect the wide range of different corporate lending.

Claims secured on real estate (Section 2.5)

Residential Mortgage Lending

27.   The paper outlines a two-factor model to calculate risk-weights for residential lending. We support the view that the model does present a more sophisticated capital calculation; however, we have concerns over both the factors used.

28.   While we agree that LTV at origination is a relatively good indicator of loss and/or default we do have some issues with the measure proposed particularly when assessing the risk over the life of the mortgage. While not updating the value of the property may minimise pro-cyclicality it further removes the capital calculation from economic reality. Experience suggests that default rates on seasoned loans (where asset price appreciation and repayments have occurred) and economic loss is lower and that the current levels of capital held is appropriate.

29.   In discussions with the European Mortgage Federation (EMF), it has become apparent that it would be difficult to apply a single LTV ratio across Europe because of the individual difference between national markets.

30.   The proposal would significantly move the average risk weight for mortgage portfolios higher than the existing 35% risk weight. As outlined below, it may not be practical to re-rate lenders' back-books that could conceivably benefit from the lower risk weights. Lenders would benefit from lower risk weights from re-mortgage operations – but that, of course, would encourage lenders to re-mortgage properties purely for a capital benefit. While we agree the current 35% risk-weight may be too high for some lending and too low for other exposure on average, the performance of mortgage books would suggest that 35% is a good proxy for the average risk weight of the portfolio.

31.   We would also highlight, that the current Basel risk-weights already factor in the riskiness of higher LTV lending. In the UK, the proportion of the loan above 80% attracts a higher risk-weight that raises the weight risk-weight for these higher LTV loans. We believe the current system already factors in the additional risk of higher LTV lending and sufficient capital is held to absorb these risks.

32.   New lending is likely to attract a higher risk weight than currently applied. Given the risk weights proposed this would make lending to certain borrowers, such as first-time buyers, highly unattractive. The structural issues of the UK housing market already make it difficult for first-time buyers to enter the property market and the changes in risk weights could make the cost of mortgages to first-time buyers or indeed those with small deposits, prohibitively expensive.

33.   We have concerns that the creation of a matrix of different risk weights based on the model could give rise to the opportunity for regulatory arbitrage. It could mean lenders extend several loans with different lien rankings based on the risk-weight thresholds, or a property purchase could be funded by a number of lenders on the basis of, the same thresholds. This would add complexity to the market for consumers and could potentially lead to some form of capital arbitrage.

34.   The changes in house price - the denominator in the LTV calculation - do have an impact on probability of loss (and loss at default) since owners with an increasing financial "stake" in the property owing to increasing value, are less likely to default. In particular, the LTV calculation should reflect changes in the house price that lenders could obtain either through actual valuations, using "desk-top" valuations or automated valuation methods. We note that the methodology suggested in the paper, does not capture house price rises or falls (such as where borrowers fall into negative equity). This is a major flaw in the proposed methodology.

35.   Lenders will capture house price changes at a number of points including when providing further advances, restructuring debt but not with a product switch. We believe it would make sense for lenders to take advantage of the change in facts to allow them to apply a different risk weight to the lending since it would reflect the then current risk. If the change in asset price is not included, we believe that it would significantly promote "churn" in the mortgage and re-mortgage business that we do not believe would be good for lenders or consumers.

36.   However, the operation of the market would present further issues to consider: if a revaluation of the property was allowed when a further advance was proposed it could create a scenario where a lender could increase the indebtedness of a borrower but benefit from a reduction of the risk-weight (depending on the additional advance and the movement in house prices).

37.   The use of LTV calculations may also mean the creation of a fragmented and segmented mortgage market with lenders providing mortgages at different LTV's. On its own the LTV calculation would not capture additional borrowing a consumer might take on to complete a house purchase if lenders are constrained from lending at high LTV's because of the capital cost. (We acknowledge that this could be captured by the Debt Service Calculation (DSC) or as currently happens in the affordability stress test; however, it would not capture future indebtedness or changes in circumstances).

38.   This would also have significant impact on the back books of lenders. The use of historic LTV calculations does not reflect the current risk of the mortgages. Any introduction of new risk weights for mortgages should, therefore, exclude back books.

39.   We do not consider the DSC as currently proposed a good indicator of future loss or default. For example, "life changing events" e.g. divorce may be a better predictor of loss/default but are very difficult to predict. We have reservations of the use of income or debt multiples as a predictive tool for default because of how such a calculation can change rapidly over time and of how the ratio is calculated in the first place. If Basel were to proceed with this type of model and methodology, we would favour using a LTI calculation. This ratio is already used within the UK industry as part of the affordability tests. It would be an additional burden and cost to have to calculate both LTI and DSC ratios to reflect both national and international regulatory requirements. However, we would note that even the use of an LTI ratio raises concerns and question its predictive power with regard to default and loss.

40.   Furthermore, the definition of DSC would appear to result in lower capital requirements for some loans with potentially higher risk (e.g. Interest Only mortgages).This would appear contrary to the ambition of the proposal to introduce more risk sensitivity into capital calculations.

41.   As with LTV, a historic DSC will provide only a limited, snapshot view as to the potential loss over time. As consumers' circumstances change, both positive and negatively, it will affect the likelihood of loss etc., but would not be tracked given the proposed methodology. It would be extremely hard for lenders to track this data.

42.   Most lenders do not have the historic data to calculate the DSC, and in any case, this historic data will provide little insight to the probability of loss. We, therefore, do not think the DSC could be fruitfully applied to lenders back books.

Buy-to-Let (BTL)

43.   We also have concerns how the proposals would affect the BTL market. The paper is ambiguous in the approach of how BTL could be classified. Professional large (organised as a limited cos.) landlords could be classified as specialist lending given the criteria of "income-producing real estate financing" thereby attracting a higher risk weight (120% vs. the current 35%). Alternatively, individual landlords might be classified as 'other retail' and attract a 100% risk weight. It would be inconsistent to have different risk weights for essentially similar lending secured on residential properties.

44.   Given that BTL lending is secured on residential lending and, therefore, displays many of the default/loss characteristics of that asset class, we consider that BTL lending should be classified as residential lending and attract the same risk weight as this asset class. This is consistent with the conclusions of the Capital Requirements Regulations (CRR).

45.   The proposal that covers the change in risk weight for residential property i.e. the use of the two-factor model based on both LTV and DSC would be an inappropriate risk tool for BTL lending. Market practice is to lend at lower LTV levels than residential lending (75-80% LTV) and lenders focus on rental cover of interest payments (Interest Service Cover, ISC) rather than LTI or DSC variables

46.   It should be noted that the Bank of England proposes to undertake a consultation in 2015 which will potential provide a macro-prudential overlay to the regulation of BTL mortgages and in particular may include some minimum level of rental cover needed.

47.   We would also draw Basel's attention to the work undertaken during 2011 to 2013 at EU level in the drafting of Capital Requirements Directive (CRD IV) and the Capital Requirements Regulations (CRR). The issue of the appropriate risk weight for BTL was raised and in conclusion, the weight of evidence meant that BTL lending in the UK maintained its existing 35% risk weight. In our opinion, no new evidence has been presented that would change the conclusions reached in the lengthy CRD/CRR process.

48.   If the proposed changes did occur, we estimate that a number of lenders would withdraw from the BTL market and interest rates on BTL mortgages would have to rise.

Q.10: Do respondents agree that LTV and/or DSC (as defined in Annex 1 paragraphs 40 and 41) have sufficient predictive power of loan default and/or los incurred for exposures secured on real estate?

While we acknowledge that LTV does have some predictive power for loan default as mentioned above, the failure to recognise the dynamic nature of asset prices means that the ratio can quickly lose it predictive value. To maintain its value asset price increases/decreases need to be included. We would re-iterate that the use of such ratios, particularly when they are not updated to reflect current economic reality could lead to perverse outcomes for example, re-mortgaging and extending additional advances to a seasoned loan could attract a lower risk weight than an existing mature loan on the back book.

We have more concerns over the DSC calculation. In the experience of UK lenders, DSC has rarely been a predictive characteristic in retail mortgage scorecards. Again, the weakness of the ratio when imposed on a global basis is the different national tax and payment systems. Likewise, the failure to update a DSC ratio would immediately weaken its predicative value; however, the ability of lenders to update this ratio regularly is limited.

Q11: Do respondents have views about the measurement of the LTV and DSC ratios? (In particular as regards the keeping of the value of the property constant as measured at origination in the calculation of the LTV; and not updating the DSC ratio over time.)

No further comments.

Q12: 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?

No further comments.

Q13. 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 age of a loan secured on a residential property ('loan vintage') has proved to be a reliable risk factor in this asset class. Mortgage loans older than seven years, for example, show a reduced default rate and subsequent loss than younger vintage mortgages.

49.   This response has been prepared by the CML in consultation with its members. If you have any comments or queries on this response, please contact the CML representative Jon Saunders, Senior Policy Adviser: jon.saunders@cml.org.uk +44 20 7438 8934