The voice of banking

EBA RTS on conditions for capital requirements for mortgage exposures

A response by the British Bankers' Association

October 2015

Introduction

The BBA is the leading trade association for the UK banking sector with more than 200 member banks headquartered in over 50 countries with operations in 180 jurisdictions worldwide. Eighty per cent of global systemically important banks are members of the BBA. As the representative of the world's largest international banking cluster the BBA is the voice of UK banking enabling us to represent our members domestically, in Europe and on the global stage. Our network also includes over 80 of the world's leading financial and professional services organisations. Our members manage more than £7 trillion in UK banking assets, employ nearly half a million individuals nationally, contribute over £60 billion to the UK economy each year and lend over £150 billion to UK businesses.

The BBA is pleased to respond on behalf of its members to the EBA's RTS on conditions for capital requirements for mortgage exposures

Key messages

The BBA's main concern is the emphasis that the paper puts on the role of LGD in the future stability of the financial system. While it is of course essential to set the appropriate risk weight in the context of retail exposures secured by residential or commercial immovable property, there are a whole range of macro and micro prudential tools (for example, stress testing) that are far more suitable for regulating financial stability than the risk weighting of LGD, and we would ask the EBA to take this into account when considering the use of LGD.

We are also have comments on a number of other important issues including the material overlap between the proposed measures and pre-existing capital adequacy controls, the risk insensitive nature of the proposed changes for IRB and disproportionate impact on low risk lending strategies, and the inherent difficulties around making adjustments on the basis of the forward looking immovable property market developments.

Please find further details in our answers to the CPs specific questions below.

The BBA would be happy to provide any further assistance or support on this matter as appropriate.

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Annex

Question 1: Do you agree with the three main categories of conditions specified for the setting of higher risk weights (paragraph 1) and the setting of higher minimum LGD values (paragraph 2)?

We broadly agree with the three main categories as appropriate should the risk weights be changed. However, we ask the EBA to consider the following observations:

- The security of an institution should be considered under the stress testing framework. This would give competent authorities the scope to require capital above the regulatory minimum after judging each firm on their individual merits.

- There is a strong possibility that an increase in minimum risk weights could disrupt lending to the real economy, particularly given that such a change is without precedence.

- Given the difficulties with ensuring accurate forecasting, it would be preferable if actions could instead be based on observations. Focusing any measures on new lending, rather than back book, would more directly target areas of concern.

- We are concerned that these proposed changes to Pillar 1 capital calculations may not fit with existing Pillar 2 measures. For example, increasing RW% and LGD% Floors will overlap with Pillar 2 Capital measures, while the Capital Planning Buffer is already in place to cover stressed losses. The Capital Planning Buffer would be expected to decrease where LGD Floor increased.

- In any case, we are concerned that firms may not realistically be able to implement these changes in the set timeframe, and ask the EBA to give further thought to how this would work in practice (for example, as is being in other consultations on changes to the IRB framework).

- It remains unclear as to how the process would practically define an appropriate LGD floor.

- Different approaches for Standardised and IRB banks would lead to disconnect between the two models, and we are therefore concerned that this will not promote a level playing field between the SA and IRB approaches.

Question 2: Do you agree with the conditions for specification of the loss experience and the loss expectations? Do you agree with the adjustments allowed to be made to the loss experience on the basis of the forward-looking immovable property market developments?

In principle we do agree with the CP, but it should be noted that developing a view as to future expected loss is inevitably judgemental. The suggested areas of investigation are reasonable, and we agree it is right to emphasise the impact on risk weights of a switch in exposure to unsecured retail as property prices decline.

However, it remains unclear how the final expected loss rate would be obtained. Making adjustments on the basis of the forward looking immovable property market developments is problematic, and there is no reliable methodology for forecasting asset prices, while adjustments made based on such forecasts would be subject to high error margins.

We would therefore recommend adjustments are based on historical experience are preferred.

Question 3: Do you agree with the indicative benchmarks for the assessment of the appropriateness of the risk weights and to guide the setting of higher risk weights across immovable property markets in different member states as specified in Article 4(3) and 4(4)? What levels of these indicative benchmarks would be most appropriate and why?

We are unconvinced by the use of possible triggers and/or benchmarks. The CP suggests two possible approaches with different outcomes underlining the judgemental aspect of the approach. We believe the burden should be on the Competent Authorities to justify any change in minimum risk weight with reference to the previously identified forward indicators.

The ranges of loss expectation relative to risk weights are broad and, at the lower end, a small increase in loss expectations may lead to a large increase in risk weight.

We note that in the UK the largest single year loss is 0.26% in 1993.

Without further consultation it's difficult to comment fully on the proposed benchmarks. At the upper end of the 35% RW benchmark, 1.5%, it's not clear to us why a standard deviation would apply. Whereas at the lower end why recovered assets would not be recognised as in the case of default BTL regulations (CRR Articles 125/126 paragraph 2(b)).

Question 4: Do you agree with the specification of the term of "financial stability considerations"?

We agree with specification, and the definition of financial stability is sufficiently wide ranging to give Competent Authorities the necessary discretion to make prudent decisions. Despite this, we would however refer to the key message above that LGD is not an appropriate tool for controlling overall financial stability.

Question 5: Do you agree with the other conditions for the setting of higher risk weights? (Please provide your feedback related to the indicative benchmarks (in Article 3(3) and 3(4)) in your response to Question 3 above.)

We would again direct the EBA to the key message, and question why changing risk weights is deemed the most appropriate approach.

We suggest regulators also take into account discretionary controls should not lead to duplicative or multiplicative capital requirements. As explained above, increasing RW% and LGD% Floors will overlap with Pillar 2 Capital measures, the Capital Planning Buffer is already in place to cover stressed losses, and the PRA Counter-Cyclicality buffer is in place to promote financial stability.

We would also expect regulators to provide comprehensive explanations of any decisions they make.

Question 6: Do you agree with the conditions for specification of the exposure weighted average LGD and the LGD expectation? Do you agree with the adjustments allowed to be made to the average exposure weighted LGD on the basis of the forward-looking immovable property market developments? Do you agree that it is not appropriate to set indicative benchmarks for the setting of higher minimum LGD values because of the specificities of national immovable property markets and because of the relationship of the LGD parameter with the other internal model parameters?

We ask for the following to be considered:

- Thought should be given to the principle behind why a minimum LGD is set i.e. because some exposures with very high levels of security and where in the event of default it is very unlikely that any loss will be experienced might carry little or no capital which regulators are reluctant to sanction. We are wary that any change in the minimum LGD demands a good understanding of the status of the portfolios caught by the minimum LGD and the scope for limited losses even in a severe downturn, which in turn requires specific national expertise.

- We notice that no mechanical link is proposed between the expected and the minimum LGD and agree with this approach as changes to the minimum LGD should only be considered in exceptional circumstances, and judgement is required.

- Making adjustments on the basis of the forward looking immovable property market developments is problematic. There is no reliable methodology for forecasting asset prices, and adjustments made based on such forecasts would be subject to high error margins. We recommend adjustments based on historical experience are preferred.

- Increasing the LGD portfolio floor decreases IRB model sensitivity and disproportionately affects low risk organisations, thus favouring higher risk strategies. It not clear under what economic conditions this tool would best bring about financial stability. Model changes focussing on collateral values would maintain sensitivity, for example ‘Peak-to-trough’ house price assumptions or ‘ Collateral Haircuts’.

- There needs to be a better explanation of how average LGD forecasts can be converted into practical LGD floors.

- Adjustment should be made to the Mortgages market as a whole. If segmentation is preferred this should be predefined with sufficient lead time to enable institutions to adapt their model infrastructure. The current infrastructure makes it difficult to act on individual portfolios, e.g. where short market history, as LGD floors may overlap.

- As highlighted above, any change in the minimum LGD should be at the discretion of the Competent Authorities, but decisions should be transparent and supported by a comprehensive explanation.

Question 7: Do you agree with the other conditions for the setting of higher minimum LGD values?

The subjective nature of the requirements, combined with the difficulty of answering all questions with a high level of confidence in a timely fashion is causing concern. The following additional factors should be taken into account:

- Discretionary controls should not lead to duplicative or multiplicative capital requirements. Increasing RW% and LGD% Floors will overlap with Pillar 2 Capital measures, the Capital Planning Buffer is already in place to cover stressed losses, and the PRA Counter-Cyclicality buffer is in place to promote financial stability.

- The question should be asked as to whether the LGD Model infrastructure enables the desired action to be implemented across all institutions on an equal basis.

- Regulators should demonstrate why this is the best discretionary control tool to use at this moment in time.

Question 8: Do you have any suggestions on the Impact Assessment?

Please see the comments throughout this response.