Council of Mortgage Lenders

Discussion Paper: Future of the IRB Approach

Response by the Council of Mortgage Lenders to the EBA Discussion Paper

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 European Banking Association (EBA) discussion paper on the “Future of the IRB Approach”. 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. We are supportive of the general principle that regulation of financial institutions is an evolving process and that there is a requirement for both the regulated and the regulator to be constantly improving the regulatory framework to ensure that the regulatory process captures the evolving risks.

5. However, changes in the regulatory risk based framework have to occur when new or different risks are identified. We remain sceptical that there has been a sufficient re-evaluation of the historic asset performance to justify wholesale changes in the IRB approach.

6. Changes to the risk methodology that result in a requirement for lenders to hold more capital should reflect identified changes in risks, based on the statistical data that lenders hold for portfolios of assets. A general across the board increase in capital required, could lead to higher pricing for consumers and risk lower lending volumes with a consequent negative impact to economic growth. We recognise however, that regulators need to have confidence in the application of the IRB models and the results they produce. Lenders are keen to work with regulators to improve the overall level of confidence in the risk-based system. We would note that improvements in the methodology should not necessarily produce a higher capital requirement.

7. Lenders are supportive of the risk-based system of capital calculation (both the standardised and IRB approaches). The risk-basked approach relies on a sophisticated methodology to produce a capital calculation. We acknowledge that it can however, produce anomalies within the market. Following the crisis, regulators have taken steps to improve both the risk-based formulation and overlaid a non-risk based approach e.g. the introduction of a leverage ratio to provide a “belt and braces” approach to capital regulation. Improvements in the risk-based system of capital calculation should reduce the need for, and the potential use of, macro-prudential tools.

8. We would argue that it is important that the regulator allow the reformed and enhanced regulatory architecture to “bed-in”. This would allow the regulator to assess more accurately the efficacy of the improvements in the risk-based capital calculations, the addition of a non-risk based assessment of capital required and the changes in lender behaviour generated by enhanced conduct regulation.

9. In addition, we would also highlight that any timetable for substantial changes in the IRB approach have to reflect a process where both lenders and regulators have sufficient time and resources to enable models to be updates and approved.

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Specific comments

4.3.1 Definition of default

10. We note that the discussion paper highlights that different definitions of default are an area that contributes to the discrepancies in the risk-weighted asset (RWA) calculation. In particular, it highlights the differences in national jurisdictions between the definition of default for amounts that are past due more than 90 or 180 days.

11. It is not necessary to repeat the arguments made in response to the debate around the Capital Requirements Regulations (CRR), and specifically Article 178 (1)(b) which devolves power to national regulators to vary the number of days past due to define default. We would merely re-inforce the view that national regulators need some flexibility to vary the requirements of the CRR to reflect the specific operational and risk parameters of individual jurisdictions.

12. In terms of cross jurisdiction comparison, we would acknowledge that this does provide external observers an additional complexity. However, we would contend that further disclosure and transparency would alleviate some of these concerns.

4.5 Possible future regulatory developments

13. While we agree with the sentiment of constantly “improving the consistency and comparability of the regulatory capital requirements”, we have concerns with any approach that devalues the IRB approach and substitute it with a less sophisticated approach. We are not convinced that a reduction in the reliance on internal models will allow the regulator to maintain an adequate risk sensitive approach.

14. In response to the Basel Committee for Banking Standards (Basel) consultation on “Revisions to the Standardised Approach for credit risk”, a number of issues were identified. The general approach, with regard to mortgage credit risk, was the proposal to introduce a more complex risk based system that we would support. However, the two-factor model as proposed by Basel would not produce a more accurate assessment of the risks within a standard mortgage portfolio. In addition, there were significant, perhaps unintended consequences, for other mortgage portfolios e.g. Buy-to-Let and Social Housing portfolios.

15. The consultation also proposed a significant alignment of risks between firms using the Standardised and IRB Approaches. While we have sympathy with this approach, we would not want to sacrifice the additional sophistication and risk identification inherent within the IRB approach simply to allow ease of comparison between firms on different capital calculation methodologies.

16. Before any of the Basel proposals become part of the EU framework, considerable further refinement is required. In addition, we would expect a further level of consultation to occur at an EU level to reflect the specific dynamics of individual mortgage markets within the EU.

4.5.1 Low Default Portfolios (LDPs)

17. The discussion paper suggests that, given the difficultly of modelling the risk parameters of LDPs particularly the Loss Given Default (LGD) calculation, that it may be more appropriate to use an alternative approach for example the application of the Standardised Approach. The discussion paper highlights a number of potential portfolios for example exposures to central governments etc. but not residential mortgage portfolios.

18. We would emphasise that LDP’s are not synonymous with portfolios with no defaults: where lenders have portfolios of a statistically significant size and can provide data over a period of time and through economic cycles, this does provide strong and robust evidence to support the Probability of Default (PD) estimate. We recognise in these cases, the estimation of LGDs is a challenge and that there may be a case to use some universal approach across lenders to provide consistency when

establishing the LGD for such portfolios. We would welcome further discussion on potential improvements in this area.

19. While the IRB approach does produce a very low risk-weight (RW) for prime residential mortgage portfolios in the UK, we feel that there is sufficient historic data to enable lenders to model these portfolios. While they may in practice, appear a LDP, we would propose that lenders continue to use the IRB approach for these portfolios. We would note that the UK regulator already imposes a floor on the RW to prevent RWs falling too low.

20. However, within the UK mortgage industry there are other portfolios which do demonstrate the characteristics of a LDP as described in the discussion paper. In particular, we would highlight the performance of lending to Social Housing Associations in the UK. This is a sector where no investor has sustained a loss for over forty years. In terms of appropriate RW, lenders using the Standardised Approach currently apply the same RW as they would for prime residential mortgage lending. We would contend that some recognition should be given for the default record at that perhaps a modified RW should be applied to this asset class. The IRB model can generate a significantly lower RW for a UK residential mortgage portfolio. We would therefore suggest that the appropriate RW for social housing lending is somewhere between the RW generated by the IRB models and that currently used in the Standardised Approach.

4.5.3. Harmonisation of exposure classes

21. We believe that it does make sense for similar assets to attract similar RWs. We do not think that the regulatory methodology that a lender uses should generate different risk weights for essentially the same asset class and that there should be a level playing field across business models including the regulatory oversight. However, the logical conclusion of that, we believe, for residential mortgages would be a reduction in the RW used in the standardised approach.

22. The IRB Approach, is a significantly more sophisticated and risk sensitive approach to calculating the various parameters which generate the RW. We would oppose a reversion to a less accurate and more subjective method of calculating RWs for this asset class.

Conclusion

23. We welcome the EBA initiative to improve the IRB approach. As stated, capital regulation should be an evolving and iterative process with the regulator working with the industry to refine and improve capital calculations. We would, however, note that any changes to the IRB approach (and hence changes to the internal models of lenders) is inevitably a complex and time-consuming activity. We welcome further discussions on this subject but highlight the proposed period for change as outlined in the document as highly ambitious. In addition, in our opinion of the need for regulators to assess the effectiveness of the existing regime (including the operation of the leverage ratio and new conduct regulation), changes in the IRB approach should be considered over a significantly longer period of at least five years

24. 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