Council of Mortgage Lenders

**Consultation on RTS on conditions for capital requirements for mortgage exposures**

**Response by the Council of Mortgage Lenders**
**to the EBA Consultation Paper**

**Introduction**

1. The CML is the representative trade body for the residential mortgage lender industry that includes banks, building societies and specialist lenders including credit unions. Our 131 members currently hold over 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 consultation document issued by the European Banking Authority (EBA): "Draft Regulatory Technical Standards on the conditions that competent authorities shall take into account when determining higher risk-weights, in particular the term "financial stability considerations" under Article 124(4)(b) CRR and the conditions that competent authorities shall take into account when determining higher minimum LGD values under Article 164(6) CRR". We are happy for our response to be made public.

3. Our views on these proposals necessarily reflect our interest in their impact on mortgage lenders and the residential mortgage market.

**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)?**

4. We have sympathy with the view of regulators that the regulatory framework needs to incorporate flexibility concerning the risk calculations given changes in market conditions and ensure financial stability. However, we have concerns with any changes to Pillar 1 calculations. We believe that the correct response to a change in the risk environment should be additional capital requirements within Pillar 2 rather than changes to the global standards enshrined in Pillar 1.

5. In our view, the proposed changes have the potential to duplicate the capital requirements calculated under Pillar 2. The introduction of a range of capital buffers within Pillar 2 e.g. the counter cyclical buffer, the capital planning buffer and indeed additional capital required after the application of various modelled, scenario stress tests already allow competent regulatory authorities to apply higher capital requirements as a response to changing market and risk environments. In this way, changes to risk weights or LGD floors have the potential to effectively duplicate powers to increase capital held that the authorities already have.

6. Therefore, while we agree with the need to ensure financial stability we do not think that changes in SA risk weights or LGD floors are the appropriate tools to achieve this goal.

**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?**

7. The ability to predict accurately expected losses from forward looking property market developments is fraught with difficultly. We are sceptical of the ability for regulators to clearly identify expected loss trends from forward looking data and whether the data itself will accurately predict the eventual loss development on assets and, in particular, mortgage portfolios. UK regulatory authorities already have access to a significant pool of data on the historical performance of mortgages and the time lag for authorities to have access to this data is, in our opinion, minimal and would not undermine or compromise the effectiveness of a policy response to the identification of an increase in risk in this asset class based on historical data.

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**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 the immovable property markets in different member states as specified in Article 4(3) and 4(4)? What levels of these indicated benchmarks would be most appropriate and why?**

8. The introduction of benchmarks will allow for a consistent application of higher risk weights across jurisdictions for a given level of loss expectations. For residential mortgage assets in the UK, we would propose the following to reflect the historical performance of this asset class. The proposals as currently formulated do not include any granularity to reflect the different performance of sectors within the mortgage market. The proposed changes in RWs are therefore a blunt tool to reflect the change in loss expectations across mortgage portfolios with considerable differences in underlying risk characteristics. We therefore, propose that different loss benchmarks should reflect the co-mingled asset portfolios that reflect the constituency of most lenders mortgage books.

9. Given the relative unsophisticated calculation of capital using the SA approach for asset portfolios we would contend that this probably over estimates the capital needed, particularly for mortgage portfolios. We would therefore follow the methodology within the consultation paper which outlines that the RW of 35% covers a maximum loss of 2.8% (35%*8%=2.8%). We do have some concerns with the assumption of a two SD distribution for expected losses however and would therefore conclude that for lenders using the SA approach the following matrix should apply:

Losses < 1.5%: RW 35%

1.5% < Losses < 5%: RW between 35% and 100%

Losses >5%: RW between 100% and 150%

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

10. As highlighted above, we have concerns over the appropriateness of forward-looking immovable property market developments in assessing the potential for higher expected losses from residential mortgage portfolios. Forward-looking assessments can be subject to a significant degree of error and we question whether such forward-looking benchmarks are accurate in assessing current (or future) risk of mortgage portfolios. We would also add that within the UK, the Financial Policy Committee (FPC) have the ability to introduce risk reduction regulation on the origination process, for example, limits on the amount of high Loan-To-Value (LTV) advances lenders can undertake. Such tools have a direct impact on the mortgage market and more efficiently curb the risk (at origination) rather than higher risk weights / higher capital requirements. As such, increase capital requirements deal with the impact of poor lending decisions and higher than expected losses, policy intervention at origination has the potential to curb these lending decisions and therefore negate the need for higher capital requirements.

**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).**

11. In deciding to change a RW, we welcome the requirement that the competent authority needs to provide a transparent and full explanation as to why increasing RWs are required to mitigate risk for financial stability considerations. Likewise, we feel it is essential that the relevant authority provide a clear and easily definable definition to delineate the property segment in question.

12. In that regard we would also highlight that, to enable lenders to formulate a response to the various new regulatory proposals, clearer definitions of various terms including for example loss, particularly expected loss would aid the discussion.

13. We would also highlight the apparent divergence in approach for some sectors of the mortgage market i.e. Buy-to-Let (BTL). This is inconsistent with the approach within CRR, which

providing the BTL sector in a given jurisdiction meets certain requirements is treated the same as residential property. We believe that this link should continue.

14. We believe that the regulators already have sufficient discretionary tools and that the proposals should be structured so that they do not lead to duplicative measures. As noted above, increasing the RW% and LGD% Floors overlap with the Pillar 2 capital measures already in place. Should these additional policy tool powers be granted, we think that the regulatory authorities need to explain under specific circumstance when changes in RW% or LGD% floors are employed as a policy tool as opposed to other (Pillar 2) policy responses.

**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 the specificities of national immovable property markets and because of the relationship of the LGD parameter with the other internal model parameters?**

15. Regulatory authorities already have the capability to set LGD floors within IRB models. We do not however believe that the potential floor should be determined by reference to the SA calculation. By doing so, regulatory authorities would be required to omit valuable data sources that give a useful indication as to the risk of a given portfolio.

16. In addition, we do not think the mechanical link between changes in the current LGD and the LGD expectation onto a minimum, LGD is appropriate. Changes to the minimum LGD should occur only in exceptional circumstances and be based on concerns for financial stability solely.

17. Raising the LGD portfolio floor reduces the sensitivity of IRB models and has a significant impact on low risk business models. Model changes that maintain sensitivity while increasing prudence would be more optimal e.g., adjustments to the floors in the models based on “Peak-to Trough” or “Haircut” floors.

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

18. As highlighted above, any changes in the minimum LGD should be at the discretion of the relevant regulatory authorities but decisions should be transparent and supported by a full explanation.

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

19. We would like further clarification as to the rationale that regulators will use in deploying risk reduction policy tools. In addition to the proposals contained in this consultation, regulatory authorities already have an arsenal of potential policy responses to a rise in risk on mortgage books. Lenders remain confused as to when a particular policy tool will be used and how the regulator will differential between the deployment of different tools.

20. 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