Increasing mortgage risk weights under CRR Article 124

Response to EBA CP 2015 / 12

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Building Societies Association

Introduction

The Building Societies Association (UK) is pleased to contribute to the EBA's consultation. As all our members are specialised residential mortgage lenders, the majority using the standardised approach, this matter is of great importance to us. For that reason, we concentrate in this response on RWs for loans secured on **residential** property only. We also support the EU-level response from the European Association of Cooperative Banks, to which the BSA belongs.

Setting the right guidelines is of great importance to all mortgage lenders across the EU. On the one hand, if and when evidence emerges of **significantly** higher loss experience, this should be recognised, and if genuinely necessary, can be appropriately reflected in higher risk weights. On the other hand, there is a risk of regulatory over-reaction, from two possible routes. The first, based on lazy stereotyping, prejudice and selective anecdote rather than proper objective evidence of higher loss experience, is all too easy to contemplate. That is the main danger that we think these guidelines (alongside the provisions of CRR Article 124) should guard against. The other particular danger is that the calibration of the threshold for any increase is wrong, given the broad brush nature of the existing 35% RW for residential mortgage loans. We explain this concern below. Finally, there is the general concern over increasing procyclicality.

General observations

We think the EBA has done a thorough job in drafting these guidelines. The provisions governing the matters that national competent authorities (NCAs) must consider seem suitably comprehensive, but also clear and relevant.

Our principal suggestion is that the guidelines should make clear not only which matters must be considered, assessed, or determined by the NCA, but go further and **require the NCA to publish its assessments and determinations, and the evidence used to arrive at these**. We cannot accept a "black box exercise" where the NCA makes assessments and determinations without disclosing the analysis and evidence base to allow proper scrutiny.

We find the EBA's approach towards calibration open and logical. The material in the draft CBA / Impact Assessment was particularly helpful in understanding the proposals and proposing calibration ranges. Our general concern over the calibration of thresholds for any increase is as follows.

The existing range of residential mortgage lending covered by the 35% risk weight under the standardised approach is quite broad – within this bucket, there will be much lending that is extremely safe, and some that involves slightly higher risk. Lenders using IRB already reflect this in the more granular IRB risk weights they apply – for much mainstream residential mortgage lending, these RWs are well below 35%. Moreover, evidence published by the UK's PRA in the context of its Pillar 2 methodology for credit risk also confirms what our member societies also tell us - that the 35% RW tends to **overestimate** the credit risk for **conventional residential mortgage lending**. So the 35% RW bucket can contain a notable element of higher risk lending before that RW ceases to be a fair reflection of the overall credit risk in that bucket. However, if types of lending with a higher loss experience are identified, and separately given a higher RW in accordance with article 124, the overestimation of the credit risk of the lending remaining in the 35% RW bucket will be increased, as there is no mechanism to reflect the improvement in the bucket's credit risk resulting from segmenting and separating the riskier lending. So it is especially important that thresholds are set high enough that only lending that is shown to be **substantially riskier** results in higher RWs under this procedure.

We expect the underlying process called for under Article 124 is likely to have procyclical effects – because the first emergence of the evidence that leads to determination that higher RWs for certain lending types are justified by substantially higher loss experience is likely to be correlated more with a downturn phase, than with a steady state or recovery phase, in a member state's economy or lending market. We welcome the EBA's explicit recognition of the procyclicality danger, at least in Article 3.2 of the RTS. What else can the EBA do to mitigate any procyclicality resulting from these guidelines?

Responses to specific questions

Question 1 :

Yes, the specified three main categories are a clear and logical way of organising the matters that should input into the NCA decisions.

Question 2 :

Yes, the conditions, and the range of possible adjustments, are sensible. But the NCA should be required to publish, with appropriate supporting evidence, the matters which it has determined.

Question 3 :

The explanation of the alternative lines of argument derived from other provisions of CRR – set out in the CBA – is clear. **We think the first argument (that maximum losses of 2.8%, corresponding to a loss expectation of 1.5%, are covered by the 35% RW) is by far the more convincing**, and the result is more consistent with CRR RWs generally.

Moreover, we are not sure if the second argument is correctly applied anyway – 0.3% (derived from Article 125) is stated as the benchmark for increasing risk weights above 100%, when in fact the effect of losses exceeding 0.3% is that the RW for residential mortgage loans that do not satisfy the independence criterion in Art. 125.2(a) moves from 35% to 100%. So 0.3% is in fact the threshold - in the Article 125 context – for increasing the RW above 35%. In that case, the EBA should perhaps have stated the lower bound of its indicative range as 0.3%, not 0.10%.

However, these thresholds can never be a matter of exact science. Since the available time series of loss data may also be short, we think (independently of the two arguments above) to begin with at least the benchmark should anyway be set at the upper bounds of the indicative range – i.e. for residential mortgages – loss expectation of up to **1.5%** (corresponding to maximum losses of **2.8%**) is adequately catered for by 35% RW, loss expectation above **1.5%** but no more than say **5%** catered for by higher RWs between 35% and 100%, and only where loss expectation exceeds say **5%** should the RWs be set in the top range of 100% to 150%. (It may also be necessary to define loss expectation more specifically.)

The other reason for setting the benchmark at the upper end of the range consulted on is to mitigate, or at least prevent aggravation, of the general problem that the 35% RW already tends to overestimate credit risk in conventional residential mortgage lending, as explained above.

Question 4 :

Broadly, yes – the specification of financial stability considerations covers the right ground, and we particularly support the need to take account of procyclicality. But we caution against the following unintended effect: if one G-SIB, or several smaller banks, in a particular member state mismanage lending of a particular type and thereby incur serious losses, the right remedy might be to increase Pillar 2 add-ons for these banks (only), rather than increase Pillar 1 RWs for all

credit institutions, including those who have managed the same types of lending successfully. We suggest the EBA includes a provision in these RTS to make clear that Pillar 1 RWs should not be increased to deal with idiosyncratic issues at one, or a few, banks, when the right tool is Pillar 2.

Again, for these reasons, transparency is paramount – unless the NCAs publish their evidence and reasoning, it will be difficult to challenge what may be the wrong use of this Pillar 1 tool, skewed by one or two hard cases.

Question 5 :

Yes, these conditions are broadly fine. The NCA should have to publish whatever it has determined.

Question 6 and 7 :

As previously indicated, the requirement for NCAs to consider 'the expected evolution in immovable property market prices and the expected volatility in those prices…' and 'the time horizon over which the forward-looking property market developments are expected to materialise…' should be accompanied by a requirement for the NCAs to make explanations public as to the reasoning behind their views on the future direction and timing of property price movements. Without such explanations it will be difficult to assess the level of conservatism being applied in the NCAs' thinking and avoid suspicion of over-conservatism and subjectivity.

The logic for not setting indicative benchmarks for higher minimum LGD values appears sound.

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Our members have total assets of over £330 billion, and account for approximately 20% of both the UK mortgage and savings markets