UK FINANCE

A response to the PRA's consultation (CP14/20)

Internal Ratings Based UK mortgage risk weights: Managing deficiencies in model risk capture

Introduction

UK Finance is the collective voice for the banking and finance industry. Representing more than 250 firms, we act to enhance competitiveness, support customers, and facilitate innovation.

The consultation's purpose is indicated in paragraph 1.4 as "to address the prudential risks from inappropriately low IRB UK risk weights", with an "additional benefit" of "narrowing of differentials between IRB and standard approach (SA)", and to "support competition between firms on different approaches." The proposal sets out to address different and potentially conflicting objectives of:

- promoting greater comparability with other jurisdictions
- ensuring effective capital and risk management of mortgages at all stages of the economic cycle
- supporting competition by narrowing the differentials between firms using IRB and standardised approaches

We are pleased to respond to PRA's consultation on UK mortgage risk weights. We welcome the overall objectives of the PRA to promote competition but have some reservations about whether the proposals will necessarily address its concerns effectively over the medium term, given the impending introduction of Basel 3.1, or meet the objective of fostering a more competitive UK mortgage market.

As envisaged in the consultation, the proposals will affect our members differently depending on their business model, risk profile and the nature of any leverage or regulatory capital constraints. Reflecting this, in the section below we have set out our members' perspectives, both common and different.

Key messages

It is important that risk sensitivity is reflected in the measurement of risk weighted assets (RWA) in the bank capital framework, to ensure that firms and the banking system, as a whole, appropriately allocate capital and price risk. The proposed design of the risk weight floors for mortgages, whilst benefitting from simplicity, is likely to significantly reduce the risk sensitivity currently provided by IRB models. We can understand the PRA's desire to have a more targeted form of 'guardrail' for low-risk weights on UK mortgages than the leverage ratio can provide, but it is essential that any risk weight floor is not 'over-calibrated' and thereby eradicating risk sensitivity across a wide range of prime UK mortgages.

We also believe that the mortgage markets across the EU vary considerably and the risk weight floors applied by other EU countries are not a particularly appropriate point of reference for establishing a risk weight floor for UK mortgages and the PRA should not rely on this as a strong supporting argument.

The risk weighting provided under the current Standardised approach and the future approach under Basel 3.1 are based on broad global averages and are not calibrated for the specific nature and risks of the UK mortgage market. So, we do not think that floors should be applied in order to raise IRB model UK mortgage risk weights toward Standardised risk weight levels.

It would be more appropriate to address concerns over competition though continued encouragement and facilitation of UK lenders moving to the IRB approach, or where this option is not appropriate (for small firms) to introduce a UK-tailored standardised risk weighting approach. As the UK is no longer constrained by the EU CRR rules and the Basel standards have been designed for larger international banks, this UK-tailored standardised approach should now be possible.

Section 1.9 of the consultation expresses concern about managing tail risk. Tail risk can be managed by Pillar 2B assessment and not limited to the Pillar 1 position. In this case an IRB firm's Pillar 2B will be more risk sensitive to the downside scenarios that drive the tail risk than Standardised firms where the RWA will be relatively stable other than migrations to default or an increased proportion of loans being > 80% LTV due to negative House Price Index (HPI) adjustments. We consider that whilst the Pillar 1 view is important it is not the complete picture. Therefore, it should be possible to reducing the Pillar 1 impact through a lower floor on the basis that Pillar 2B provides a better mechanism than floors for managing tail risk.

The following section of this document cover the above points and other issues in further detail.

Mortgage market characteristics - comparability with other jurisdictions

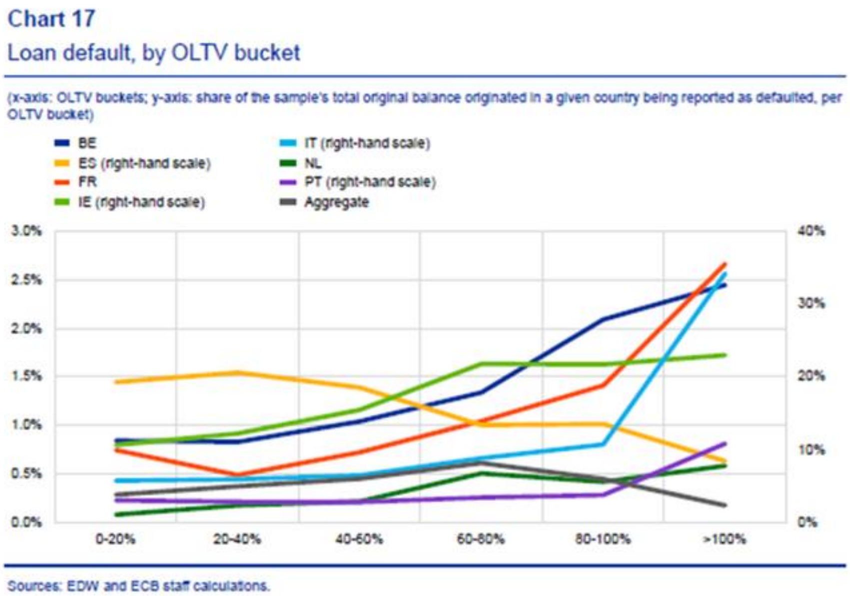
Differences between the risk weighting for mortgages under the Standardised and IRB approaches are an embedded feature of the international bank capital framework established by the Basel Committee. Standardised approaches are inherently less risk sensitive than the IRB approaches and are calibrated on an international basis rather than being tailored to individual jurisdictions such as the UK.

In the background section of consultation paper, the PRA have cited other European countries which have introduced similar measures and that these measures could bring the risk weight for UK IRB mortgages closer to European average of 13% for IRB and 35% for standardised (20% at lowest band post 2023 following the introduction of Basel 3.1).

We note the divergence in quality of mortgages across European countries as shown in the chart below from ECB paper[1] covering default rates of residential mortgages. The Standardised risk weight is applied to a wide cross-section of international peers and yet, following the introduction of Basel 3.1 a risk weight of 20% at the lowest LTV band will apply equally to all

[1] https://www.ecb.europa.eu/pub/pdf/scpops/ecb.op220~47edfcc84d.en.pdf - page 25

lenders/jurisdictions despite significant divergence in default rate at similar LTV levels. We therefore suggest that the **lower IRB risk weight for UK is appropriate given UK mortgage default rate remains lower than European counterparts, even under stress**.



In the last 25 years many jurisdictions (particularly in the EU) have seen significantly higher default levels on mortgages than the UK for a variety of reasons, including different approaches to recovery or insolvency as well as the nature of domestic housing markets. Therefore, the current differential between IRB and Standardised risk weights in the UK for mortgages is unsurprising. Loss given default components also vary widely across Europe, reflecting the varying creditor-friendliness of legal systems.

In the UK, in most circumstances, and at most times, repossession can be exercised within months of default. Furthermore, the end-states are either possession or cure. **In the UK suspended possession orders are not prevalent and are intended in any case to provide a principled, if delayed, path to cure**. In other jurisdictions, repossession is at best uncertain, and when it occurs, can takes many years. Possession-to-sale is not meaningfully constrained in the UK, whereas it is constrained and thus slowed in other countries. This time to possession-then-sale matters. The most material differences to the UK have historically been in Italy where time to possession-then-sale estimates of up to seven years are realistic. For balance, Italy's reforms in 2016 [Law No. 119/2016] may be reducing this to a smaller number of years; but we consider that a downturn time-to-possession or time-to-sale on the basis of expected future improvements as unrealistic.

A modal mortgage loss-given-default (LGD) of 100% would be unrealistic in the UK, unlike Italy[2] where possession is far from certain. Although cross-country estimates of most LGD components are not easily obtained, historical HPI patterns can be examined to assess the position of the

[2] https://www.ucd.ie/geary/static/publications/workingpapers/gearywp201226.pdf – see fig.1. – page 12

prescribed UK 25% HPI downturn among European countries[3]. This shows that the UK's 18%[4] decrease over 6 quarters from Q3 2007, whilst more than some countries[5] is materially lower than many EU countries. In short, a 25% downturn assumption for Ireland would not fully represent the last downturn. Consequently, a common downturn principle applied to LGD across the various EU countries is very likely to result in variation in risk weights by LTV.

Country	% Downturn from 2007-08 Peak
Belgium	3%
France	8%
Portugal	16%
UK	18%
Denmark	18%
Cyprus	19%
Netherlands	21%
Spain	37%
Lithuania	38%
Estonia	47%
Latvia	50%
Ireland	54%

Thus, **with material differences in country probability of default (PD) by LTV, and even more material LGD differences, cross-country comparison of risk-weights by LTV is not a valid basis to apply a material risk weight floor to UK mortgages**.

Timing of implementation - IRB approach evolution, Economic conditions and Future capital & MREL requirements

It is important when considering the use of adjustments to IRB modelled risk weights for mortgages (such as risk weight floors) that the **PRA takes into account the steps being taken internationally by the Basel Committee in Basel 3.1 to introduce more risk sensitivity to the standardised approach** which will result in a significant narrowing of the gap between IRB and Standardised risk weights for UK portfolios. The RWA output floors introduced by Basel 3.1 reforms will be implemented through a phased approach between 2023 and 2028. Whilst the floors contemplated in this consultation could achieve some of the PRA's goals, **we have concerns regarding their immediacy of their necessity and also their calibration. In fact, we consider that the floors introduced in this consultation will in effect bring the impact forward.**

Additionally, as it plans Basel 3.1 implementation, we strongly **encourage the PRA to** diverge from the requirement that mortgage LTV should be assessed using the property value at value at origination and **retain the current value approach**. **This will ensure the risk sensitivity of the standardised approach and ensure greater consistency with the IRB approach – house prices can go down as well as up.**

Stamp duty changes have provided a welcome temporary support to the housing market. The **capital impact of this consultation could trigger pricing changes shortly after the lower stamp duty**

[3] https://ec.europa.eu/eurostat/data/database?node_code=prc_hpi_a
[4] Note that the 2019 Markit index shows a larger decrease from the 2007 peak than this Eurostat series
[5] Germany, Luxembourg, Finland and Sweden did not experience any meaningful HPI decrease in the same period

comes to an end. This two-factor impact could reduce housing demand and may artificially induce house price falls – which will have the opposite of the desired effect in terms of financial stability.

The PRA is concerned that the modelled mortgage capital requirement has declined significantly over the past decade due to lower PDs in benign economic conditions and lower LGDs as house prices had continued to increase, prior to the Covid 19 crisis. **The original rationale for the consultation may have been overtaken by the impact of the current medical crisis, the ensuing economic down-turn and consequent impact on PDs, LGDs and house prices.** This is suggested in the Bank of England's December 2020 report of the FPC which indicates "some headwinds …are therefore anticipated over coming quarters as unemployment rises, business insolvencies rise from current low levels, and **risk weights on banks' exposures increase**". This increase in risk weights would also feed through to mortgage portfolios and should be a consideration.

Furthermore, it should be noted that **market underwriting standards have improved significantly**, adopting lessons from the last recession, with many backstop controls codified into regulation e.g. FCA's Mortgage Conduct of Business Handbook affordability testing, Financial Policy Committee limits, buy-to-let underwriting standards. High quality, risk sensitive rating systems should respond to this as older, high risk business leaves the book and is replaced.

Lenders are pricing new business now with uncertainty about future capital requirements. If introduced consideration should be given to mortgage floor being applied to new lending after a certain date in the future, not introduced in full retroactively on historic lending portfolios without a transitional period. Also, the **combination of MREL and leverage regulations already adversely impacts lenders focussed on low-risk mortgage who use the IRB approach**. **Potential unintended consequences of the proposals in this consultation are the cost of raising more capital or MREL resources which may in turn curtail new lending and hence competition.** The increase in risk weights from January 2022, particularly if applied retroactively, could impact the timing and quantum of members' MREL requirements. Some of our members' working assumption is that this is a material change in capital requirement and therefore should be subject to a multi-year transition period - is this the PRAs view? If not, then the change suggests that some members may need to raise additional MREL capital earlier than planned, potentially by end of next year before the proposed new measures.

Capitalisation 'guardrails' and impact on risk sensitivity

The leverage ratio has a very different impact across firms - some firms' business models mean the leverage ratio is much less binding than risk-based ratios, therefore making the leverage ratio insignificant for control of risks from IRB model risk weights in such firms. In contrast, for some firms, in particular those heavily focussed on UK mortgage lending which use IRB models, the leverage ratio is the key 'front stop' for determining capital levels and overrides any risk of inappropriately low IRB risk weighting for mortgages.

We do acknowledge that the use of IRB risk weighting floors would be a mechanism to provide a 'guardrail' to the levels of capitalisation of mortgages across all firms (not just leverage-constrained firms), which could address, albeit in a crude way, perceived model risk. We expect that the effect of the Basel 3.1 output floor, as is the case for the leverage ratio, will ultimately also be to some degree dependent on firms' business models / business mix.

Blunt mortgage risk weight floors however have the potential to notably reduce risk sensitivity for firms using the IRB approach. It is important therefore that, if introduced, the levels at which mortgage risk weight floors are set should be proportionate to the perceived prudential risk level, so that suitable risk sensitivity is retained in the risk-based capital framework, particularly given the significance of UK mortgages as an asset class to UK firms.

The introduction of a 7% RWA floor as well as at a 10% portfolio level floor is likely to impact low LTV lending in particular, which will result in either an increase in customer costs for low LTV products, or IRB firms focussing on higher risk segments to optimise return on regulatory capital. Even in higher (origination) LTV segments over the latter part of 10-year valuation cycle the 7% floor on RWA will have impact as capital payments and HPI increases could be expected to reduce LTV. Hence even higher LTV mortgages will be brought within scope of the floors merely by the passage of time. This could act as disincentive to sell relatively high-risk assets to maintain 10%.

In terms of stakeholder perception, **reporting and disclosure will also be particularly challenging through this period with the increased risk of misreporting throughout the sector**. **This increases complexity and reduces transparency**, making it much more difficult for stakeholders to understand the changing position.

A **move to a more standardised approach to measuring of PDs of portfolios that are fundamentally cyclical by overlaying with floors creates challenges from a risk management perspective**. It creates a level of complexity making the understanding of how all the components act together more difficult. There will also be unintended consequences if the resultant cost of risk on mortgage portfolios is higher than the cost of risk on other portfolios.

Supporting competition and impact on low-risk lenders and portfolios

Although the proposal could be argued as supporting a more level playing field for the lenders under standardised approach, it will **disincentivise lenders from ensuring risk discipline** by maintaining a portfolio comprised of low-risk assets, as there would be no capital benefit to doing so, and as margins are lower returns on the portfolio will be lower. **This could lead to an increase in the average risk profile of the industry and its potential exposure to economic shocks**, in contradiction to the Bank of England's financial stability objectives. Also, by encouraging large incumbents to pursue more vigorously the higher return subsegments, margins will be reduced thus disincentivising new entrants and specialist market participants which currently serve these sub-segments. Therefore, **an unintended consequence of the proposals may be to in fact increase hurdles to new competitors building a market presence. This is at odds with the current focus of the authorities to keep the new lending markets open to foster economic recovery from the effects of the medical crisis**.

Furthermore, the RWA risk-pricing signal will be removed at low LTVs for IRB market participants leaving only the weaker provision signal already common across IRB and standardised market participants. The consequence will be less pricing differentiation on lower LTVs as lending rates will be floored by the risk weight floor.

The risk weighting multiple between IRB and standardised will still be multi-fold at the floor; by definition this will remain the largest positive Standardised-IRB risk weight gap. Standardised approach institutions will only gain to the extent that they price-take at higher lending rates. The risk weight gap would be closed in a way that achieves little for competition.

Other issues

We have other concerns too:

- We note that certain industry participants have attempted to quantify the financial impact of the consultation using firms' **Pillar 3 disclosures**. Whilst the disclosures are generally sufficient to quantify impacts of the portfolio-level floor in isolation, they **do not contain sufficient detail to accurately quantify the impact of the exposure-level floor**. This is because **disclosures contain *average* risk weight by PD grade and therefore do not detail the distribution of risk weights that contribute to the average**. For example, risk weights may vary significantly within a PD grade due to LGD. In the event that some firms are unable to populate the data template we urge caution in attempting to infer impacts from pre-existing disclosures.

- We understand that 7% individual mortgage risk weight floor would also apply to defaulted mortgages. Under the IRB approach such mortgages may have low risk weighting, but the capital requirements for such exposures also include a large expected loss (as probability of default for such mortgages equals 100%). **As such, it seems inappropriate to apply both a 7% risk weight floor alongside the required capitalisation due to the expected loss** for such mortgages.

- **If a large portion of rating system outputs are in effect over-ridden by the RWA floors, thereby eliminating the rank ordering ability of the rating system, we are concerned about the ability to evidence compliance** with the **CRR Article 144-use-test** requirement. In effect, the underlying behavioural and/or application model will still be a component of the rating system that will be monitored, even though it is overridden by the floor. This will **introduce an irreconcilable dissonance – expectation of underwriting and managing as if there is risk weight differentiation and evidencing the same, but nonetheless with the application of a risk weight floor.**

- Most UK banks hold 12% - 15% of CET1 capital per unit of RWA. **A 7% risk weight floor would therefore equate to equity held against the lowest risk mortgage lending of 84 bps - 105 bps**. These implied loss absorbing rates, especially for the lowest risk cohort of lending from the UK's more sophisticated lenders, seem **very high relative to historic and extreme stress experience for UK mortgage lending as a whole.**

- **The proposals act as a disincentive to firms which develop high quality, discriminatory models as a large proportion of lending will be below the individual floor (7%) even under stressed conditions**. Whilst our members' individual submissions of Appendix 2 template will identify the proportion of lending below the individual floor, the following high level analysis attempts to estimate the scope.

The 5% exposure level LGD floor already acknowledges that a valid downturn LGD can be less than 5% at low indexed LTV. Therefore, it is instructive to calculate what long-run probability of default (LRPD) would result in a 7% risk weight and examine how that relates to industry wide historical default rates. 7% risk weight and 5% LGD imply a LRPD of 1.1%. Consider the example on slide 8 of the 5th October 2020 Bank of England roundtable[6]. The "third-party" default rate is inferred from Council of Mortgage Lenders arrears stock data. Notwithstanding that different default rates can be inferred from the arrears stock, a reasonable simple average on a 90-days-past-due basis of the annual time series from 1988 to 2016 is 1.2%. Therefore, the average UK long-run default risk combined with the 5% LGD floor will be affected by the risk weight floor. From the Q3 2020 MLAR[7], which shows 56% of regulated mortgage stock at or below 75% LTV, it is reasonable to estimate that at least 25% of mortgages being on the 5% floor. Since at least half of mortgages must have a below average PD, this **implies a scope of the individual floor of at least 12% of mortgages**. **Excluded factors such as asymmetrical PD distribution and LTV correlation with PD imply that the affected proportion will be higher. Overall, this appears to be an overly broad scope for a risk weight floor.**

Of course, I and UK Finance members would be happy to discuss our response further with the PRA to arrive at a mutually beneficial approach whilst still addressing the PRA's objectives "to address the prudential risks from inappropriately low IRB UK risk weights", with an "additional benefit" of "narrowing of differentials between IRB and standard approach (SA)", and to "support competition between firms on different approaches." We do not believe flooring mortgage risk weights is the appropriate way to achieve this.

Responsible Executive

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[6] https://www.bankofengland.co.uk/-/media/boe/files/prudential-regulation/publication/2020/irb-mortgage-roundtable-october-2020.pdf
[7] https://www.bankofengland.co.uk/-/media/boe/files/statistics/mortgage-lenders-and-administrators/2020/2020-q3.pdf