Implementing Basel 4 in the EU

BSA response to Commission public consultation

January 2020

Building Societies Association

Introduction

The Building Societies Association (BSA) appreciated the opportunity to take part in the Commission's valuable conference on 12th November 2019, and is now pleased to respond to this public consultation. We have input the elements of this response, as appropriate, into the Commission's online questionnaire, and are submitting this complete memorandum as an attachment. We repeat many of the points we made in our previous response[1], to the Commission's exploratory consultation, in April 2018, and also set out new advocacy on developing issues.

The BSA represents all 43 UK building societies, all of which are credit institutions under CRR /CRD, specialising in residential mortgages and savings. None is a large, internationally active bank, although one is an O-SII and a few do use internal-ratings based approaches (IRB) for credit risk. The great majority use the standardised approach (SA), and around 35 out of 43 will qualify as small, non-complex banks (SNCBs) under Article 4.1 item (145) of the revised CRR.

Our response concentrates on those questions of direct relevance to our members, and the wider question of the appropriateness of some of the Basel framework for small, non-complex institutions. The BSA belongs to the European Association of Co-operative Banks and supports the great majority of the collective response from the EACB which has been submitted in parallel with our own. We refer on specific issues to the more detailed analysis contained in the EACB's response.

[1] https://www.bsa.org.uk/information/industry-responses/basel-4-implementation-in-the-eu

General observations - proportionality

As we explained in detail in our April 2018 response, what is most needed now is far more systematic proportionality in the application of Basel-derived rules to small, non-complex banks. As is well known, the Basel Agreements apply formally only to “Basel banks” – large, internationally-active banks. Some jurisdictions only apply Basel rules to a handful of their large banks. But the EU, ostensibly for single market / single rule book reasons, has applied practically the whole of each successive Basel regime to all credit institutions with no, or very little, differentiation even for the smallest and least-complex banks. We recognise and respect the efforts the Commission has so far made to re-introduce proportionality, following on from the 2015 Call for Evidence under the REFIT initiative, and with some limited but important and welcome measures already adopted in the “CRR 2” dossier – such as the legislative recognition of the small, non-complex bank now in Article 4.1 item (145). But without further, explicit action by the Commission now, the default paradigm for Basel 4 implementation will remain application to all EU banks regardless of size or complexity. We regard this approach as fundamentally at variance with the right to proportionality founded in Article 5 of the Treaty on European Union. We have worked with cooperative banking federations from many other member states[2] to produce in June 2019 a common position paper[3] which we respectfully draw again to the Commission’s attention.

We remain convinced that the right answer for the longer term is a systematically simplified, and administratively less burdensome, regime for smaller and non-complex banks – i.e. what has been described as the “small banking box” – rather than continuing and adding to the limited patchwork of exemptions. We fully supported the initiative during 2017 from official and industry stakeholders in Germany. The key insight from leading commentators is that the “small banking box” should not, and does not, endanger financial stability in any way. There is no question of lowering resilience standards for smaller banks. What is needed is systematic relief from the administrative burden of very complex rules, and of extensive reporting and disclosure requirements, that are typically relevant only to larger and publicly quoted entities. Worthy of consideration, though not for exact copying, is the recent experiment in Switzerland[4].

We also fully understand the Commission’s desire, for geopolitical reasons, to avoid the appearance of material non-compliance with Basel. Since smaller banks, that are not internationally active, are out of scope for Basel anyway, this need be no obstacle to a systematically simpler (but not weaker) regime for SNCBs.

Failure to grasp this opportunity is not without cost or risk. One of the strengths of the EU banking sector, especially in certain member states, is plurality and diversity. Decentralised cooperative and savings banks and (in the UK) building societies are a cornerstone of this plurality and diversity, and thereby helped sustain the flow of finance to the real economy and to citizens and households, when the largest banks were hit by the banking crisis. But the burden of excessive and pointless regulation now threatens the success, perhaps even in some cases the survival, of the small, non-complex banks. A wave of regulation-driven consolidation would damage this plurality and diversity and leave the EU banking sector more concentrated, and therefore more fragile, and less responsive to the needs of citizens and SMEs. That is why we urge the Commission to go further than it has so far ventured, and embrace the principle of the “small banking box” at the same time as implementing Basel 4.

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[2] DE,AT,IT, PO, ES ,LU and UK

[3] https://www.bsa.org.uk/information/industry-responses/proportionality-in-eu-banking-regulation

[4] FINMA launches regime for small banks (July 2018)

Other priorities

Within the wider topic of proportionality, the key issue for smaller banks is **administrative burdens**, whether deriving from one-off implementation or from recurring obligations. We explained in our April 2018 response that one of the greatest implementation burdens would lie in the detailed reclassification of our members' existing residential mortgage books according to the new risk weighting buckets and according to LTV based on original valuation. In our previous responses[5] to the Basel Committee we pointed out that the standardised approach for credit risk as regards residential real estate worked satisfactorily, was not broken, and did not need to be fixed. The driver for change was entirely down to the apparent need to revise the SA as a prelude to the introduction of output floors for IRB users, and had little relevance to SA users. We said in April 2018 that transitional measures would be needed if SA banks are not to have to devote a lot of scarce resource to re-cutting the historic back book rather than concentrating on the new lending of the future.

For that and other good reasons, **we strongly support the proposal, originally developed by German colleagues, for SNCBs (at least) to be permitted the option to remain on the current standardised approach for credit risk, at the cost of a simplicity premium of 7%** (based on the EBA impact assessment for smaller banks).

Detailed responses

Where we support the detailed EACB response on matters of less, or no, relevance to our own members, we say so in the online questionnaire. We have endeavoured to include elements of our response under the nearest appropriate question, but at times this proved very difficult or impossible. Accordingly, we are submitting our few detailed points in this single document which we will upload.

Residential mortgage lending (SA)

Original valuation

The most serious issue affecting our members under the proposed revised standardised approach is the question of risk weighting according to LTVs based only on original valuation

According to the Basel Agreement (but, it appears, contrary to the current provisions of CRR and to the approach that EBA is suggesting in its draft Guidelines on loan origination and monitoring), institutions should be using only the original property value measured at the time of loan origination or the result of a downward-only revaluation, if deemed necessary (footnote 37). In its advice from August 5th 2019 the EBA sets out two options as a way forward: option 2 would give the possibility to revise the property value over the lifetime of the loan, and we would recommend following this route.

[5] https://www.bsa.org.uk/information/industry-responses/our-response-to-second-basel-consultation-on-revis ; https://www.bsa.org.uk/information/industry-responses/our-response-to-basel-committee-consultation-on-re

Indeed, we contrast the approach of the BCBS with the requirements of CRR Article 208(3)(b), connected to Article 125(2): the value of residential property collateral would be monitored at least every three years. In our opinion, if LTVs are to be the prime determinant of the SA risk weights, they should be accurate, that is, calculated on the basis of a reasonably current property value as well as the current effective debt outstanding.

Moreover, in considering the suitability of the new Basel requirement for European circumstances, it is necessary to take account of fundamental differences between most EU residential mortgage markets and those, for instance, of the USA, as it is feared the latter unduly influenced many of the final terms of the latest Basel Agreement. The European tradition, generally, may be characterised as "originate to hold" – that is, the original lender expects to retain the customer relationship, and the loan asset on its balance sheet, for the lifetime of the loan. While some European lenders have made some use of securitisation, the "originate to hold" model remains predominant, and- in our view – preferable for consumer protection reasons. By contrast, the US model may be characterised as "originate to distribute/on-sell" with the original lender to a much wider extent offloading existing mortgages via securitisations.

It is also necessary to bear in mind the near-universal experience in mortgage lending that (*ceteris paribus*) the likelihood of default (measured under IRB by the PD) is greatest in the first few years of the loan. Then, after a period of, say, three years without delinquency (i.e. "seasoning") the propensity to default has fallen substantially. So the RW framework should discourage, or at least not encourage, constant refinancing, with the temptation to make "equity withdrawal", instead of progressing to repay the original loan.

A simplified example might best illustrate how the Basel original valuation feature will incentivise riskier outcomes :

Borrower X has bought a house costing € 100,000 with an initial loan of €86,000 from lender A : at 86% LTV this loan carries a RW of 40% under Table 11 (on page 21 of the Dec 2017 Basel text).

After 3 years, X has repaid a total of €5,000 but considers refinancing her loan. The house vaue has now risen to € 110,000. Lender B has no difficulty offering a loan of €81,000, based on the current valuation, which gives a LTV of 74%, requiring a RW of only 30% under table 11. For lender A, however, the LTV based on original valuation remains at 81%, keeping the RW at 40%. So, B is able to undercut A's mortgage rate as the capital cost of its loan is 25% lower , for near identical risk.

But the perverse incentives do not end there, as B can even offer a lower rate while tempting X to withdraw some equity from the property, all at the lower RW. X now fancies spending €6,000 on some expensive jewellery, and wants to take the cash out of the increased value of the house. This would take her total debt to € 87,000. Lender B is quite relaxed, as this will still take its LTV to only 79% and therefore still a RW of 30%. For lender A, the RW has to stay at least 40%, even on the original amortised amount of €81,000 – so this RW is actually higher than for B's proposed loan of €87,000 on the same property. And if A allows any equity withdrawal, the RW will get close to the 50% bucket.

So, what does lender A do? While the normal practice would be to provide the extra money as a "further advance", A realises that to keep borrower X it has to game the rules. So, via a lending subsidiary, it offers X a completely new loan of € 87,000 at the current valuation of €110,000 at a 30% RW. The new money repays the orginal loan to A itself, leaving the borrower with € 6,000 to spend on jewellery. This is what Basel facilitates, but should the Commission and the EU necessarily follow suit?

So, we demonstrate above that being required to adhere to an original valuation (that may be well out of date) will create serious perverse incentives where the borrower is considering refinancing. The rule would in fact encourage repeated switches of lender: for the same loan (monetary amount) and the same property, the risk weight (and thus the pricing) applied by a new lender could be lower if there has been an increase in property value since the original loan was made, as the new lender will (indeed, must) use the latest valuation, while the original lender cannot. The risk, of course, is almost the same (in fact, if anything, the risk to the new lender is initially greater, as it has had no prior relationship with that borrower). And as we have shown, the new lender can tempt the borrower away from the original lender, and away from prudence, by offering extra cash for spending, so increasing the burden of indebtedness, all at the same lower RW. It is essential that original lenders are not competitively disadvantaged in this way. Otherwise they will simply be driven to subterfuges such as re-documenting and re-advancing the loan in order to benefit from the new valuation. *Cui bono?*

We consider that there is a sensible middle ground, represented by what is currently in Article 208. It would be equally foolish to revalue mortgage collateral every few months, as it would be to fail to monitor property values at all. Article 208 requires monitoring at least every three years. We believe that institutions should have the possibility to reflect the result of a revaluation at intervals of not less than two years, or otherwise (for fair competition reasons) in the case of renegotiation where the borrower is proposing to refinance with another lender.

Such an approach as outlined above would be more faithful to European traditions, more beneficial to consumers, and ensure fairer competition in the refinancing situation, as well as being more in line with current risk management and underlying risk.

Loan splitting

The BSA argued strongly in favour of the loan splitting approach in responding to the BCBS' consultations, and advocated this from the relevant panel at the BCBS industry conference in Basel in February 2016. Accordingly, we strongly support transposition in Europe of loan splitting as the normative or baseline treatment. This methodology is the predominant existing interpretation of the Basel 2 framework and is already implemented quite satisfactorily in the EU via CRR.

Terminology on re-/payment (OO-RRE, IP-RRE)

In paragraph 67 of the final BCBS paper, the terminology around "servicing" and "repayment" is still used inconsistently in places, although this has improved since the **BCBS** second CP text. We explained the issue in our March 2016 response to that second CP as follows :

Servicing or repayment ?

We raise a minor point of language on paragraph 51. There is some confusion and inconsistency between repayment and servicing : the narrative tends towards the more holistic concept of "servicing" – i.e. meeting all the payment obligations under the loan, both interest and instalments of principal. But the use of the term "repayment" can only refer to principal – although usually interest makes up the majority of any regular payment obligation, interest is paid but not repaid, so repayment cannot refer to any element of interest. So both the bullet point in paragraph 50 and the text in paragraph 51 should refer to servicing the loan. This would also make clearer that interest-only loans, fully serviced from the borrower's other income, do not fall into the IP-RRE category.

Paragraph 67 has responded to this criticism, as the term "servicing" has been adopted throughout. The problem is that the headings for both Tables 11 and 12 refer to "Repayment". We think this is most likely an oversight, but it remains a concern. So we urge the Commission to treat the language used in Paragraph 67 as definitive, and correct the inconsistent language in the headings of the two Tables, when transposing them into draft CRR text – so, change “repayment” to “servicing”. In that way, interest-only lending will clearly qualify for Table 11.

Social housing

The framework for the revised SA may also have unfortunate consequences for all lending (existing and new) to a relevant part of the “social housing” sector (i.e. not for profit or charitable provision of housing at affordable rent to economically less advantaged clients).

Indeed, the new Basel approach generally seeks to make a finer distinction between loans secured on rented as opposed to owner-occupied housing. In the first BCBS consultation, most IP-RRE appeared to be excluded from the preferential RW for residential real estate under the “material dependence” criterion. It was pointed out that loans financing rented social housing should be treated as RRE, and this general point was accepted in the second BCBS consultation, along with adjustments in the final agreement also to reflect the fact that not all providers would be cooperatives as in some Member States, many/most are in fact community benefit societies, not pure tenant cooperatives. Unfortunately, a new element was added which could cause problems for certain categories of supported housing providers that serve some of the EU’s most vulnerable and disadvantaged residents.

In particular, para. 68 (pages 22-23) contains the following definition covering social housing finance as a preferential category:

“An exposure secured by residential real estate property to public housing companies and not-for-profit associations regulated under national law that exist to serve social purposes and to offer tenants *long-term* housing.”

Much of the new wording caters for the great majority of social housing providers, however there are a number of associations doing really important work by providing shorter-term housing in the form of hostels, move-on accommodation, short-term housing for the homeless, young people leaving care, refuges for women fleeing domestic violence, etc. The housing itself is clearly occupied (successively) long-term by these client categories, but (for obvious reasons) each individual resident may need / be offered only shorter-term housing, or will naturally move on to longer- term housing where possible.

We would ask the EU authorities to make the language slightly more flexible to clarify that the long term provision of such housing is not disadvantaged, notwithstanding that successive individual occupancies of any unit may be shorter-term. The associations providing it are often smaller, and therefore more reliant on bank finance than on capital markets issuance. It should be possible to find a formulation that covers such worthy activities which temporarily provide a primary residence for these vulnerable people, without also covering pure holiday accommodation or other short term occupation.

We would suggest **“…that exist to serve social purposes by the long-term provision of housing to tenants”**, this would make clear that it is the provision of the housing, rather than the duration of individual tenancies, that needs to be long term.

Operational risk

In our previous response to the BCBS CP on operational risk (OR), we addressed particularly the concerns of smaller and non-complex firms that were likely to be caught up in the EU implementation of the Basel 4 measures, but who have never attempted modelling for operational risk, or captured detailed OR loss data, so as to ensure that the replacement SMA was not excessively complex. Since those proposals envisaged that the ILM component would not be required for Bucket 1 firms, we called for measures to avoid a sharp cliff effect when a firm transitions from Bucket 1 to Bucket 2 and has to apply the ILM for the first time.

The Commission's document recognises that Bucket 1 firms do not need to calculate an ILM. Oddly, Basel 4 (paragraph 12 of the OR section) gives a general discretion to supervisors to set ILM =1 for all their banks. Our proposal was more modest : either the option to set ILM = 1 should be extended to all Bucket 2 banks ; or banks transitioning in quantitative terms from Bucket 1 to 2 should be allowed to set ILM =1 for the next three full financial years, while they build up their OR loss data set. That way these cliff effects can be avoided.

Application of IRB output floors

The BSA is on record as opposing high output floors, and questioning whether output floors are needed in addition to a binding leverage ratio – one or other would have been sufficient to guard against model risk. The very gradual implementation of the floors (2022 -27) mitigates our concerns to some extent. And if floors are to be implemented, this should be done in a way that optimises resilience where it is needed, and avoids distorting effects on competition.

The main issue at stake, clearly, is the level of application – consolidated group, or individual entity solo. Important arguments were advanced, inter alia at the Commission's 12th November conference, as to why consolidated level application is positively desirable : avoidance of fragmentation within the banking union, and preservation of diversification benefits. On the other hand, the EBA has argued strongly[6] for entity level application in its recent advice.

The BSA considers that, for financial stability reasons, output floors should be applied at least at a sub-consolidated level corresponding to "ring-fenced" retail deposit focused banks, where banking structural reform measures have been implemented at national level. The rationale is simple – the purpose of banking structural reform – along the lines originally proposed by the Commission[7] in response to the Liikanen report - is to insulate retail deposit-taking from the risks of casino-type investment and wholesale banking. Where, falling short of full separation, measures for "ring fencing" of the retail deposit entity within a single group have been implemented (as in the UK), it is clearly imperative that all resilience standards are applied at the ring fenced entity level. Otherwise "ring-fencing" is pointless.

There are also competition considerations. If a group with a ring-fenced retail entity calculates its output floors only at the overall group level, it derives an effective subsidy for its retail mortgage lending business in the application of the floor from the contribution of other business held in the non ring-fenced part of the group. The aggregating of such other business avoids the constraint on retail mortgage RWs that the floor was designed to produce, whereas this constraint will still apply to competing firms such as our own members.

An alternative approach might be to apply the output floors separately to each major asset class.

We would also support an EU-implementation where the output floor functions as a "second backstop", i.e. one of three parallel capital requirements:

[6] BASEL III REFORMS: IMPACT STUDY AND KEY RECOMMENDATIONS

[7] Structural reform of the EU banking sector

1) The risk-based requirement, i.e. “normal” capital requirements based on pre-floor RWAs consisting of the Basel requirements listed above plus any requirements for systemic risks, Pillar 2 etc. where jurisdictions find that appropriate (as currently the case);

2) The leverage ratio requirement as a separate second requirement (or one type of backstop requirement);

3) The output floor requirement as a separate third requirement (or second type of backstop) based on floored RWAs, with the floor covering only the capital buffers envisaged by the Basel Committee.

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The Building Societies Association (BSA) is the voice of the UK's building societies and also represents a number of credit unions.

We fulfil two key roles. We provide our members with information to help them run their businesses. We also represent their interests to audiences including the Financial Conduct Authority, Prudential Regulation Authority and other regulators, the Government and Parliament, the Bank of England, the media and other opinion formers, and the general public.

Our members have total assets of over £400 billion, and account for 23% of the UK mortgage market and 19% of the UK savings market.