Credit risk mitigation: Eligibility of guarantees as unfunded credit protection

Response to PRA CP 6/18

May 2018

Building Societies Association

Introduction

Building societies use guarantees for unfunded credit protection mainly through various forms of mortgage insurance for residential mortgages, and accordingly the BSA response concentrates on this area : we are pleased to provide feedback as requested (at a general level) on the nature of existing arrangements, the impact of the PRA's proposals, and other related issues. Although the BSA is not aware of any particular eligibility problems in this area, the PRA's attention is perhaps timely, as we consider that this form of CRM may assume greater significance once the "Basel 4"amendments on credit risk are implemented. And the manner in which typical mortgage insurance covering only the top-slice of residential mortgage loans is treated for CRM seems unduly complex.

Context

Traditionally, building societies used mortgage insurance - previously known as mortgage indemnity guarantees, or MIG(s) – to reduce the ultimate risk of loss on high loan to value lending, typically for the loan amounts above 80% LTV. MIG was originally used for risk management purposes only, as capital relief was not available. Although capital relief was possible for the first time under the detailed credit risk mitigation provisions of Basel II, we understand that it was most often not claimed – not necessarily because the guarantees did not meet the criteria, but possibly either due to the complexity of the applicable CRM provisions, and/or because the overall effect on the risk weighting of the whole loan may have been marginal or zero, especially where the guarantor (usually an insurer) is not highly-rated. Indeed, PRA's CP alludes to this in paragraph 1.4, stating that *"Firms may, for sound risk management reasons, wish to use techniques to mitigate credit risk irrespective of any particular capital treatment."* This exactly captures the above approach to mortgage insurance. Where capital relief was not sought, strict adherence to the CRM criteria was not necessary either.

Mortgage insurance

Building societies' current use of mortgage insurance-type guarantees mainly involves loan-by loan cover provided under master policies by specialist mortgage insurers (in contrast to the past where this cover may have been provided by general insurers as an adjunct to other business lines). Being specialists in this field, mortgage insurers are in a position to take full account of the CRM eligibility criteria when formulating and documenting their policies so that their lender clients would be able to claim capital relief if it is worthwhile to do so.

Another form of mortgage-related CRM, previously encountered in the context of mortgage-backed securitisations, was pool insurance, but we understand this is now little used, as other forms of credit enhancement are more favoured.

Finally, for completeness, we should note that there will still be mortgage loans outstanding under the Government's Help to Buy mortgage guarantee scheme : although that closed for new loans at the end of 2016, the cover was provided for up to seven years from origination. The PRA itself engaged extensively with the design of the Help to Buy state guarantee, publishing a statement in late 2013 clarifying how capital relief could be obtained, so we see no reason for eligibility concerns in this case.

Eligibility criteria

We agree that capital relief from guarantees should only be obtained where the risk has been effectively transferred to the guarantor (paragraph 1.6). We are not aware that any of the criteria mentioned in paragraphs 2.4 to 2.7 are either not understood, or not observed where mortgage insurance is used to claim capital relief. PRA already identifies the specific derogation for mortgage insurance in CRR Article 215(1) (a) that permits timely payment within 24 months. We are broadly content with the proposed clarifications, on the basis that the PRA is not seeking to restrict eligibility further from what is permitted by CRR.

Pillar 2

The discussion in the CP around Pillar 2 appears to cover two somewhat different situations. First, there is the question of how Pillar 2 should address the residual risks where a recognised CRM technique has been used to obtain capital relief in Pillar 1. Second, there is the question of how Pillar 2 should address the overall risk situation where a CRM technique is used for risk management purposes but capital relief is not claimed – in which case the full Pillar 1 capital charge applies to the underlying exposure as if no CRM was in place. The reference to Basel II suggests it is the former situation under consideration. We think it would be helpful if this distinction were made more clearly in the proposed amendments to SS 7/13.

Future treatment

As the mortgage insurance used by our members generally provides top-slice, "tranched" protection, ascertaining how capital relief can be obtained under CRR, and the calculation of the respective risk weighted amounts, becomes complex. One aspect of this complexity was the "concentration ratio" approach. Moreover, Article 234 directs firms to use the securitisation rules in Chapter 5, but without further signposting, the application of these rules to the different situation of mortgage insurance is difficult. This complexity was one reason why the PRA provided its helpful statement in late 2013 on the capital treatment of the guarantee under the Help to Buy scheme, and specified that the same treatment would be extended to private sector mortgage insurance with similar contractual features. The 2013 statement remains accessible on the Bank / PRA website. We suggest it should be revised to provide an up to date general explanation of the capital treatment of mortgage guarantees, and either incorporated into SS 7/13 or re-issued separately.

Looking ahead to the implementation of "Basel 4", the revised credit risk mitigation text appears on first reading to take a simpler approach than the existing CRR, based closely on the Basel II text. Much of the detail of the eligibility conditions remains unchanged, though it is useful to see in footnote 85 (page 50) an explicit recognition of prudentially regulated insurance companies as eligible guarantors. We would encourage PRA, when implementing and applying the Basel 4 standards in due course, to ensure that the treatment of mortgage insurance as a distinct CRM technique is clear and comprehensive.

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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 £387 billion, and account for 22% of the UK mortgage market and 18% of the UK savings market.