Constraints on the use of internal model approaches

BCBS consultation on reducing variation in credit risk-weighted assets

June 2016

Building Societies Association

Introduction

The Building Societies Association (BSA) is pleased to respond to the BCBS' consultation. The BSA represents all 44 UK building societies, which together have total assets of over £345 billion and, together with their subsidiaries, hold residential mortgages of over £270 billion, 21% of the total outstanding in the UK. They hold over £250 billion of retail deposits, accounting for 18% of all such deposits in the UK. They employ approximately 40,000 full and part-time staff and operate through approximately 1,550 branches.

The BSA belongs to the European Association of Co-operative Banks. **We strongly support both the EACB's preliminary input on this consultation in the letter dated 30 May 2016 from the EACB's President to the Chair of the BCBS ; and the EACB's full formal response to the CP being submitted in parallel with our own.** As other EACB members have greater knowledge and expertise in relation to other asset classes, our own response will primarily focus on the treatment of loans secured by residential real estate, which is our own members' core business.

General observations

A small number of the BSA's largest members use, or are progressing towards using, IRB approaches for credit risk, while the majority by number of our members are and will remain standardised users. But the member societies already using, or about to use, IRB account for over 75% of the total assets of the building society sector, so the IRB proposals will have an extremely significant impact on our sector. In common with many other respondents and commentators, **we doubt that the proposals are compatible with the BCBS' mandate from the G-20 GHOS not to increase overall capital requirements significantly**. Indeed, the BCBS IRB proposals have the potential to inflict considerable (and avoidable) damage on mortgage and housing markets, both in the UK and in other jurisdictions.

Scrapping the IRB approach, which has become a major risk management tool, for some entire risk exposure categories also seems overzealous and counterproductive. For example, the mooted removal of IRB for well-developed and secured residential retail IPRE lending to consumers, where in many jurisdictions there is a long history of data upon which to build robust models, will have significant detrimental impacts on capital requirements and potentially very harmful consequences for consumer choice and the wider residential property market. At the very least the BCBS should consider allowing national regulators the discretion to retain IRB for those portfolios where a modelling approach is evidentially both sensible and conducive to good risk management.

We support the EACB's argument that the alleged excessive variability in capital requirements can be effectively addressed by other measures, without the damaging consequences of the BCBS' proposals. Further understanding of this variance could be achieved by the publication of benchmarking data, whereby the range of internally modelled regulatory requirements by risk level within portfolios are disclosed, facilitating comparability without compromising the advantages that robust models give to good risk management practice.

Specialised lending – IPRE

The BSA fundamentally disagrees with the BCBS' apparent proposal (final paragraph of section 2.2. of the CP) "to remove IRB approaches for specialised lending" in respect of income producing residential real estate (IP-RRE – a subset of IPRE, within specialised lending).

There is, first of all, a problem of shifting terminology. In the original Basel II framework, specialised lending was quite explicitly a sub-class of corporate exposures, and included non-retail IPRE. But retail IP-RRE clearly belonged to the retail exposure class. The parallel Basel second CP on revising the standardised approach has embraced the new taxonomy by which all mortgage lending constitutes a new real estate exposure class, including IPRE (both IP-RRE and IP-CRE) and ADC. In that CP it is clear that IPRE is *not* specialised lending. But the Basel IRB CP follows neither taxonomy consistently, appearing to propose (see Annex to CP : Mapping table) that IPRE is treated as a sub class of specialised lending for IRB purposes, but also that within the retail exposure class, mortgages are only included if they are to owner occupiers (OO-RRE). We must therefore conclude that only OO-RRE falls within the retail class, while IP-RRE is to be included with other IPRE under Specialised lending. This is what we strongly oppose. Instead, IP-RRE should be explicitly left within the **retail** exposure class, and thereby remain susceptible to modelling.

Looking at the BCBS's own criteria for modellability set out in Table 1 of the IRB CP, IP-RRE within the UK scores high on all three criteria. The quantity and quality of relevant data are good, as this is a well established market with good data capture, and an adequate run of historical experience that shows low arrears and loss levels. There is an information advantage, as each IRB using bank or building society will have up to date detailed loan level data that gives specific knowledge of the detailed risks that the bank or building society may be running, which is not available at that level of granularity to the market at large. And the robust and generally accepted modelling techniques are also well -established and will have been thoroughly reviewed and tested by the national supervisor as part of the granting of the IRB permission, and periodically thereafter. **We therefore see no evidence, in the UK at least, to support withdrawing modelling from the IP-RRE asset subclass, and strongly oppose this proposal.** If the BCBS feels it has to cater for other jurisdictions where circumstances are different, this should be done by way of national derogation – i.e. the national supervisor could have the option to withdraw modelling from IP-RRE based on a local assessment of the Table 1 criteria.

Parameter floors

One of our IRB-using members has commented that the not-insubstantial upward adjustment of the current floors for ordinary retail mortgages (which are also low risk in the UK) steps away from the founding principle of IRB – to improve risk sensitivity in capital quantification and allocation. The robustness and credibility of models and parameters will have been safeguarded through strict conditions for use, e.g. comprehensive regular monitoring, independent development and validation, regulatory approval, use of conservatism, regular audit, etc. Nor are the proposed parameter floors likely to be congruent with the BCBS' GHOS mandate.

Design and calibration of the output floor

We also consider it premature, and prejudicial, to be setting out how an **output floor** would be calibrated, given that there are still so many parts of the capital framework which are under consultation, and (as has been observed by others) it is quite possible that, as a result of other measures (including any final parameter floors, and also the leverage ratio) taken in aggregate, **IRB output floors may be superfluous** for the original purposes of the IRB review.

Indeed, it is the higher end of the range proposed for output floors that we would expect (i) to create the most damaging impacts on the mortgage and housing markets both in the UK and in other jurisdictions ; and (ii) lead to the BCBS's failure to honour the G-20 GHOS mandate not to cause a significant further increase in overall capital requirements. These concerns clearly extend well beyond our own UK market. For instance, we draw attention to the helpful contribution in the last few days from Danmarks Nationalbank in its publication Financial Stability 1st Half 2016, in which[1] it states "Crude calculations indicate that the Basel Committee's proposal for a capital floor ….. will increase risk-weighted exposures noticeably in the largest credit institutions in Denmark". (Danmarks Nationalbank also points out[2], correctly, that "The Basel Committee's proposed measures may give credit institutions inexpedient incentives, because they may enable the institutions to increase their risk without increasing their capitalisation, if the measures are binding.")

So -once other changes and adjustments have been made, the BCBS should then re-consult on (i) whether there are remaining areas of the framework where an output floor could have benefit; and – only at that point, but with the benefit of the latest QIS information - (ii) on the design, calibration, interaction with other capital requirements and disclosure of the floor.

Impact within stressed conditions

These proposed changes also impact, in aggregate, in the following way on the wider capital framework under stressed conditions. These proposals will lead to RWAs increasing for many business lines, meaning the absolute size of an institution's capital buffers will increase. However, another consequence of the proposed changes (including, especially, the move to a TTC approach) is that institutions become less sensitive to the onset of a stress (and therefore *ceteris paribus* need lower, not higher, buffers) . These two outcomes are completely incongruent. So-if these changes are implemented, they need to be accompanied by a recalibration of capital buffers.

PiT to TTC

We note that the CP envisages that modelling and rating assignments will in future be done on a through the cycle (TTC) basis, whereas at present some existing IRB users have developed, with full regulatory approval, models on a Point in Time (PiT) basis. The BSA does not take a position on the move to TTC – views on this subject may well differ where some IRB users do PiT while others already do TTC. However, we think it is essential, if the TTC basis is to be mandated for the future, that PiT users have ample time to move over to TTC. To develop, test, validate and gain regulatory approval for the necessary TTC framework is a substantial undertaking. PiT users should therefore be given a transition period of five years from the date of Basel's final IRB decisions in order to make these changes properly.

[1] https://www.nationalbanken.dk/en/publications/Documents/2016/06/Summary_and_Assessment_FS_2016_1H.pdf page 3

[2] Ibid.

Modelling coverage requirement

Under the present regime, to qualify for IRB, institutions must ensure that the great majority of their exposures are covered by modelling. Permanent partial use – i.e. retaining the standardised approach for some portfolios – is only permitted for non-significant business units or immaterial exposure classes. In the UK the materiality threshold is 15% of RWAs. But this requirement is predicated on the availability of modelling for practically all exposure classes. If, as a result of the current review, several important portfolios are removed from modelling and revert to the SA, the whole basis for allowing permanent partial use will need to be re-examined. What we need to avoid is for these changes inadvertently to make it more difficult for institutions to move to IRB for those exposure classes for which it remains available. This is not just a matter of revising the metric – if BCBS' final decisions do signal a partial retreat from IRB across the board, the principles around permanent partial use should also be questioned.

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The Building Societies Association (BSA) is the voice of the UK's building societies.

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 £330 billion, and account for approximately 20% of both the UK mortgage and savings markets