Building Societies Association

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Commission Exploratory Consultation on EU implementation of Basel 4 : BSA response

The BSA represents all 44 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 a few do use internal-ratings based approaches (IRB) for credit risk. The great majority use the standardised approach (SA). 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. We have also encouraged our member societies to contribute their individual insights and impact assessments by responding directly. **The BSA belongs to the European Association of Co-operative Banks and supports in general terms the collective response from the EACB which is being submitted in parallel with our own. We refer on specific issues to the more detailed analysis contained in the EACB's response.**

General observations – a systematic approach to proportionality needed

The Basel 4 revisions make fundamental changes to the existing Basel framework, across the whole field of credit risk – both SA and IRB, on operational risk, and in other areas. This is no mere tweaking and tinkering with details. And the corresponding implementation into EU law will be a major exercise involving a rewrite of much of the existing Level 1 texts of CRR and CRD. We therefore warmly welcome the Commission's intention to consult widely and consider impacts on the EU banking sector as part of the implementation process.

One important issue, which this major overhaul of the Level 1 texts provides the opportunity to deal with properly, is the need for more systematic proportionality in the application of Basel-derived rules to smaller and non-complex banks. As is well known, the Basel Agreements apply formally to "Basel banks" – large, internationally-active banks- only. 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 non-complex banks. **We recognise and respect the efforts the Commission has recently been making to re-introduce proportionality, following on from the 2015 Call for Evidence[1] under the REFIT initiative**, and with some limited but welcome measures already proposed in the "CRR 2" dossier. But without explicit consideration of this issue now, the default paradigm for Basel 4 implementation will remain application to all EU banks regardless of size or complexity.

However, 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 –

[1] Proportionality and diversity were Issue 4 in the Call for Evidence : http://ec.europa.eu/finance/consultations/2015/financial-regulatory-framework-review/docs/consultation-document_en.pdf

i.e. what is known 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, and we commend as an excellent exposition of the case for the **"small banking box"** a recent speech[2] by the principal thought-leader on this subject, Dr Dombret of the Bundesbank, entitled : ***" Prospects for, and obstacles to, greater proportionality in regulation – a supervisor's perspective".***

The key insight in this speech, which is relevant to the first question below, 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.

Failure to grasp this opportunity is not without cost. One of the strengths of the EU banking sector, especially in certain member states, is plurality and diversity. Decentralised co-operative 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.**

General questions from the Introduction

a) What are your views on the impact of the revisions on financial stability?

Assessing the incremental impact of each new set of measures is difficult, as institutions are experiencing sequential but overlapping regulatory changes that are all part of the post-crisis reforms initially badged as "Basel 3". As of 2017-18, our members are still completing the last two steps in the build-up of the capital conservation buffer, as well as continuing the phase-out of non-compliant legacy capital instruments. They are also about to face the introduction for the first time of a leverage ratio as a binding Pillar 1 requirement – which has a major impact on building societies as they specialise in a low-risk asset class, residential real estate loans. And the largest societies also face having to build up unnecessarily high MREL resources, because of the misplaced calibration of MREL = greater of 2 x leverage ratio or 2x RBCR, under BRRD.

Although the latest set of revisions – "Basel 4" – were supposed not to lead to any significant overall increase in capital requirements, initial reactions to the final "Basel 4" package suggest that in Europe, at least, the changes may raise capital requirements substantially. The EACB draws attention to this important point, in more detail, and on a pan-European basis.

Raising capital requirements should in principle increase financial stability. The more important question is not whether the revisions increase financial stability, but whether they take the overall corpus of prudential regulation, including capital requirements, past the "tipping point" where the marginal gain in financial stability is more than offset by the negative impact on the wider economy, by the reduction of financing capacity.

[2] https://www.bundesbank.de/Redaktion/EN/Reden/2018/2018_02_21_dombret.html?https=1

b) What are your views on the impact of the revisions on the financing of the economy?

On the asset side of the balance sheet, our member building societies specialise only in retail mortgages – i.e. residential real estate loans to individuals / households - and are not significantly involved in business lending, so we cannot speak for the financing of the economy as a whole. Within the retail mortgage sector, the impact of the output floors is likely to be the most significant element – bearing in mind that the largest lenders generally use IRB. On their own, in the absence of other measures with similar effect, the introduction of output floors would significantly reduce the availability of mortgage credit, as the capital requirement for this class of business could easily double or treble. But ahead of the Basel 4 revisions, banks will already be required – under the final text of "CRR 2" – to maintain a leverage ratio (LR) of at least 3%, with higher levels possible for G-SIIs and O-SIIs, and with even higher percentages featuring in amendments to the CRR 2 proposal under consideration in the European Parliament. If banks were made to observe an LR of say 4% or more, this is likely to prove the binding constraint – in which case the output floors may by the time they are introduced make little difference, but the impact of the final LR on financing of the economy could already – by then (2022) have been quite significant. We agree with the EACB that the overall need for output floors in parallel with a leverage ratio remains in question.

Standardised approach for credit risk

Specific questions:

c) What are your views on the revisions? Please provide details.

We consider the final Basel 4 revisions on SA-CR are a great improvement on the original proposals and the content of the second CP. We welcome the re-introduction of loan splitting as an option (paragraph 65 with footnotes 44, 45) which the BSA advocated at the BCBS' industry round table in Basel in February 2016. The new RW structure, with the loan splitting option, should avoid the damaging "cliff effects" that we have warned about. The final treatment of interest-only lending (paragraph 67) and certain "materially dependent" RRE loans to individuals (paragraph 68) are also a step forward from the previous proposals, **though more detail and clarification will be needed in the forthcoming Level 1 EU text.**

The greatest negative in the entire body of SA-CR revisions is the insistence on retention of valuation at origination, disregarding all the arguments made by the BSA and others in response to the second CP (see paragraph 62). More details are given below. We strongly urge the Commission to mitigate the undesirable and unintended consequences of this measure, if necessary by diverging from the detail of the Basel 4 package on this point.

d) How would the revisions impact you/your business? Please specify and provide relevant evidence.

The main impact on our members' business we expect to be as follows. The great majority by volume of lending in the UK mortgage market comes from IRB firms, though SA mortgage lending firms are more numerous. Hitherto, since Basel 2 implementation and gaining of IRB approvals, IRB RWs for low LTV mortgage loans have been very low, way below the 35% under existing SA, and the differentiation by LTV has been sharper for IRB than under SA. Consequently, while all our members prudently aim for a balanced portfolio, IRB lenders have a natural capital advantage at low LTVs, while SA lenders do relatively better at high LTVs, as required by first time buyers. The impact of the revised SA RWs coupled with the introduction of output floors in particular (as well as the other IRB changes) will reduce these opposite incentives. Accordingly, we would expect SA lenders to complete more strongly in lower LTVs, and IRB lenders to do more at high LTVs and for FTBs, than hitherto.

More specifically:

i. How does the revised SA-CR compare to the current approach in terms of capital requirements? Please provide an estimate, if the positive or negative difference is significant in your view, and specify the relevant revision(s).

Many of our members are still evaluating this, and we have encouraged them to report any quantitative results directly. Accurate estimation of the impact of the SA-CR revisions also depends on whether assumptions made now as to the final EU treatment, on matters where detail and clarification is awaited, prove right. With that caveat, and as an illustrative example only, one small society has estimated that – provided by virtue of paragraph 68 its buy to let lending (IP-RRE) is risk weighted under Table 11 not 12, **its Pillar 1 credit risk component will fall by around 16%.**

ii. Do the revisions affect certain assets/exposure classes more than others and – if applicable – which of the provisions of the revised framework may create these effects? Please support your view with specific evidence to the extent possible.

The SA-CR revisions particularly affect real estate lending, and as far as our members are concerned, the categories of income-producing residential (IP-RRE) and owner-occupied residential (OO-RRE). The biggest overall change is probably the move away from the approach represented by Article 125 (3) of existing CRR – whereby if property markets are adequate, with low loss rates, IP-RRE is not penalised as against OO-RRE. Now Basel 4 hardwires the opposite, subject to the exceptions in paragraph 68. So general IP-RRE will be most affected, and that is why the detail, such as the correct interpretation of paragraph 67, and the supervisory discretion embedded in the second bullet of paragraph 68, matters so much.

The issue in paragraph 67 is that the **terminology around "servicing" and "repayment"** is still used inconsistently in places, although this has improved since the second CP text. We explained the issue in our March 2016 response[3] 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 Level 1 text – so, change "repayment" to "servicing". In that way, interest-only lending will clearly qualify for the Table 11.

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

The other provision that will have the greatest impact (if not mitigated as we request) is the retention of **valuation at origination**. As we explained in our March 2016 response[4] to the second Basel CP on SA-CR :

"The most obviously perverse and counter-productive result is the inconsistent treatment of the borrower who remains with the original lender at the end of an initial product term of say two or three years, compared with the borrower who moves to another lender. Clearly if the principal is not increased, the risk is the same in both cases – indeed the first lender has better knowledge of the risk, as it has had two or three years' experience of the borrower servicing the loan. No useful risk purpose is served by either pushing the borrower to switch lenders in order to access a loan assessed at the current LTV, or driving the first lender to re-advance and re-document the loan in order to update the LTV: both simply waste frictional costs."

Our counter-proposal is that the EU should partially diverge from the Basel detail by permitting updated valuation, possibly after an initial period of 2 years from origination.

Clarification will also be needed as to how the benefit of **mortgage insurance** should be recognised under the revised SA. This has been a point of difficulty under the present regime – and recognition proved, in practice, more difficult under SA than for IRB. The potential benefit from mortgage insurance will be greater under the revised SA as without it RWs for high LTV loans will increase. But we are not clear why the final Basel 4 text specifies (paragraph 62) that the LTV bucket and RW to be applied to the exposure amount are determined before the application of the mortgage insurance – nor indeed how this is to apply at all if loan splitting is continued.

Mortgage insurance is an important element of co-financing / risk transfer which increases the availability of finance especially to first time buyers. It is vital that the recognition of mortgage insurance is deal with explicitly, coherently and after due consideration, in the Level 1 text of amended CRR. This has to be got right first time round.

e) Where do you expect particular implementation challenges and why? Please specify.

We think some of the greatest implementation challenges, apart from the need for early detail and clarification so that impacts can be assessed accurately, will lie in the **re-classification of the existing mortgage book** according to the new RW buckets and criteria, especially where the requisite information may not have been captured on computerised databases or systems. Some transitional measures (allowing simplified approximation or estimation) may be needed if firms 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.

Internal ratings based approaches for credit risk

Specific questions:

a) What are your views on the revisions? Please provide details.

We refer to the more detailed comments in the EACB's response.

b) How would the revisions impact you/your business? Please specify and provide relevant evidence.

We draw attention to one important point made in the EACB response. The handling and communication by the competent authorities of the transition to the Basel 4, particularly the effects of the output floor and the other IRB changes that will increase capital requirements, needs considerable care in order not to provoke self-reinforcing loss of confidence in major

[4] ibid

deposit-takers. Although nothing has changed in the real economy, nor in the risk characteristics or performance of firms' credit portfolios, nor in the availability or quality of firms' capital, the capital strength of IRB using firms will appear to fall, though this is purely an artefact of the substantial recalibration resulting from Basel 4. It is important to avoid any language or discourse that suggests otherwise.

More specifically:

i. How do the revised IRB approaches compare to the current approaches in terms of capital requirements? Please provide an estimate, if the positive or negative difference is significant in your view, and specify the relevant revision(s).

We refer to the more detailed analysis provided by the EACB in their response.

ii. Do the revisions affect certain assets/exposure classes more than others and – if applicable – which of the provisions of the revised framework may create these effects? Please support your view with specific evidence to the extent possible.

Again, see detail in EACB response.

c) Where do you expect particular implementation challenges and why? Please specify.

We underline some key points developed by the EACB. The biggest practical implementation issue for IRB-using firms will probably be the need to establish a complete parallel system for risk weighting all their exposures under the SA merely in order to calculate the output floor – so some process relief (again, acceptance of simplification, estimation or approximation) is desirable. Moreover, there are important technical differences between how SA and IRB are applied : for instance, different ways of recognition of valuation adjustments between SA (valuation adjustments reduce RWA) and IRB approach (include RWA before valuation adjustments) and different approaches themselves (SA: RWA include EL+UL; IRB: RWA include exclusively UL) and the related link to double counting of credit risk when applying the IFRS 9 expected loss model.

CVA risk framework

Specific questions:

a) What are your views on the revisions? Please provide details.

b) How would the revisions impact you/your business? Please specify and provide relevant evidence.

More specifically:

i. How does the current CVA framework compare to the revised one in terms of capital requirements? Please provide an estimate, if the positive or negative difference is significant in your view, and specify the relevant revision(s).

c) Where do you expect particular implementation challenges and why? Please specify.

d) What are your views on the revised CVA framework to capture CVA risks arising from counterparties currently exempted from the own fund requirements for CVA risks under Article 382 of the CRR?

We refer to the EACB's detailed comments on the CVA section. We underline the EACB's concern that the changes may (inadvertently) have increased the CVA charge substantially.

Operational risk framework

Specific questions:

a) What are your views on the revisions? Please provide details.

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.

b) How would the revisions impact you/your business? Please specify and provide relevant evidence.

We expect a fair number of our members to fall into Bucket 1, but some will fall into Bucket 2 and be required to implement loss data identification, collection and analysis to generate LC and ILM. That will include trawling through historic information going back at least five years. To keep all these data collection and retrieval tasks manageable, a single loss threshold of €20,000 is far too low for most firms. It is essential that the EU implements the discretion to raise the threshold to € 100,000 for all except perhaps the very smallest credit institutions.

More specifically:

i. Which approach for the calculation of the operational risk requirement do you use at the moment?

Practically all our members use the basic indicator approach.

ii. How does the new approach compare to your current approach in terms of capital requirements? Please provide an estimate, if the positive or negative difference is significant in your view, and specify the relevant revision(s).

Our members are still assessing the quantitative impact. The main change will, we think, be for our Bucket 2 societies which need to calculate LC / ILM for the first time. The main burden may prove administrative – data collection and retrieval – rather than capital cost. Our members do not tend to have any history of egregious losses such as from conduct or fines.

c) Where do you expect particular implementation challenges and why? Please specify.

We see data collection and retrieval on historic business posing the biggest implementation challenges, as already indicated.

Output floors

Questions:

a) What are your views on the revisions? Please provide details.

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. But we also draw attention to the more detailed and critical comments in the EACB response.

b) How would the revisions impact you/your business? Please specify and provide relevant evidence.

More specifically:

i. What would be the impact of the revised output floor in terms of capital requirements when compared to the application of the revised internally modelled approaches? Please provide an estimate, if the impact is significant in your view, and specify the relevant driver.

ii. Does the application of the revised output floor affect certain assets/exposure classes more than others and – if applicable – which of the provisions of the revised framework may create these effects? Please support your view with specific evidence to the extent possible.

Of the business areas in which our members operate, we think residential real estate loans will show the greatest effect. As mentioned above under SA-CR, the great majority by volume of lending in the UK mortgage market comes from IRB firms, though SA mortgage lending firms are more numerous. Hitherto, since Basel 2 implementation and gaining of IRB approvals, IRB RWs for low LTV mortgage loans have been very low, way below the 35% under existing SA, and the differentiation by LTV has been sharper for IRB than under SA. Consequently, while all our members prudently aim for a balanced portfolio, IRB lenders have a natural capital advantage at low LTVs, while SA lenders do relatively better at high LTVs, as required by first time buyers. The impact of the revised SA RWs coupled with the introduction of output floors in particular (as well as the other IRB changes) will reduce these opposite incentives. Accordingly, we would expect SA lenders to complete more strongly in lower LTVs and IRB lenders to do more at high LTVs and for FTBs, than hitherto.

c) Where do you expect particular implementation challenges and why? Please specify.

IRB using firms will, as a direct consequence of the output floor, be exposed to the same major implementation challenge as regards re-classification of the historic loan book, because the output floor will require IRB using firms also to calculate their Pillar 1 credit risk charge under the SA as well, prior to applying the output floor percentage. See comments above.

Conclusion

In conclusion, while the final Basel 4 text shows considerable improvement on the various preceding consultation papers, there remain a number of significant implementation challenges, as well as areas of policy where the final Basel 4 detail is regrettable.

Over and above these more detailed and specific issues, the BSA re-iterates the fundamental importance of the Commission taking a bolder step in the direction of proportionality by adopting the “small banking box” idea at the same time as implementing Basel 4.

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