A serpent underfoot

***Vince Heaney** discusses how the 'cobra effect' of new capital requirements is having unintended consequences for challenger banks in the UK mortgage market*

During British rule of India, to reduce the venomous snake population, a bounty was offered in Delhi for every dead cobra. Large numbers were killed, but the reward also prompted entrepreneurs to start breeding cobras for income. When the government realised what was happening, the reward was scrapped and the snake breeders released their now-worthless cobras back into the wild, increasing the venomous snake population. The "cobra effect", where the apparent solution makes the situation worse, is alive and well in the UK mortgage market.

Since the first Basel agreement in 1998, prudential regulators have tried to link capital requirements to risk in their aim to make banks safer. Basel I introduced "risk weights", which determine how much capital a bank must hold against a given asset and are used as a measure of the asset's riskiness. In 2004, the Basel II agreement introduced the "internal ratings-based" (IRB) approach, which allowed banks to use their own internal risk models to estimate risk. But models of the required standard are costly to set up and manage and require substantial historical data sets. While most larger banks have adopted them, smaller banks, such as the UK's "challenger" banks, tend to rely on a simpler schedule of risk weights set by regulators – the "standardised approach" (SA).

"Most new and smaller banks are required to use the standardised approach to credit risk, which has higher risk-weighted asset (RWA) requirements for certain asset classes, whereas the incumbents use the advanced internal ratings [AIRB] approach," explains Aileen Gillan, chief risk officer at Metro Bank. "For some asset classes, such as residential mortgages, the RWA is fixed at 35 per cent by the SA, while banks using the AIRB approach can have RWAs of less than 10 per cent." This means new banks can need to hold considerably higher levels of capital – more than three times – than the incumbents on the advanced approach.

"This is anti-competitive and has a significant impact on the residential mortgage market. According to Bank of England (BoE) research, firms using AIRB for residential mortgages have a 30bps (basis points) price advantage," says Gillan.

At first glance, 30bps might not seem a huge advantage, but according to *Bank Underground*, the blog for BoE staff, "in an environment of ultra-low interest rates, this is substantial: a price difference of this magnitude will lead some borrowers to prefer the cheaper lender, particularly if they are using price comparison websites. In a "best buy" table compiled by Moneyfacts, the gap between rates offered by the top and 10th-ranked mortgages was only 17 bps."

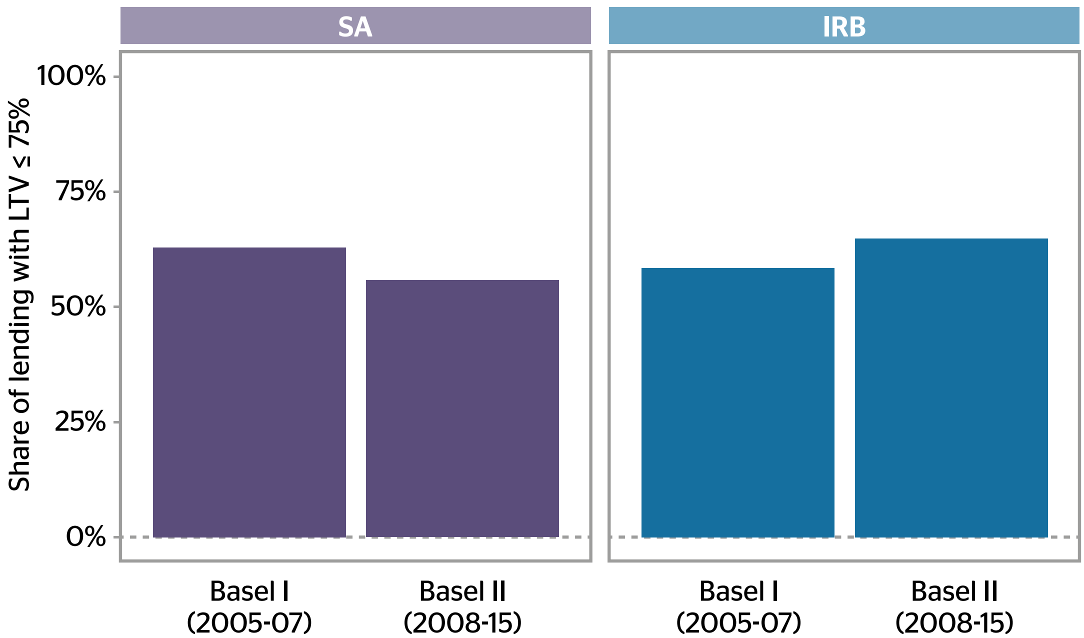
As well as placing challenger banks at a competitive disadvantage, the current system creates incentives for them to take more risk. The gap between the SA and IRB approaches to risk weightings is smaller for riskier mortgages with higher loan-to-value ratios. In February 2017, the BoE Prudential Regulation Authority (PRA) published a consultation paper, *Refining the PRA's Pillar 2A Capital Framework – CP3/17*, which highlighted that "firms using IRB models appear to specialise in low LTV (loan-to-value) mortgages, given the comparative advantage provided by their risk weights, while those using the SA tend to specialise in high LTV mortgages for which the gap in risk weights between the two approaches is smaller. This gap may create an incentive for firms using the SA for credit risk to specialise in riskier exposures. This could affect their safety and soundness."

> *"Challenger banks are at a competitive disadvantage and have incentives to take greater risks*

The use of the SA by smaller, challenger banks means they hold more capital against mortgages, which might appear safer, but has had the unintended consequence that they tend to specialise in riskier loans. BoE staff calculations show the impact of the IRB approach on the composition of banks' portfolios between high and low LTV mortgages, which has resulted in a relative shift of 12 percentage points since its introduction.

But other recent prudential regulatory initiatives help reduce the disparity in capital requirements between SA and IRB banks. For example, the systemic risk buffer applies

Portfolio share of low LTV (<75%) lending



Source: FCA Product Sales Database and Bank calculations

only to large lenders, typically using models, while smaller lenders, typically on the SA, are exempt; and the leverage ratio effectively acts as a floor preventing risk weights from leading to excessive leverage. Looking ahead, the Basel Committee has also proposed revisions to the SA and IRB approaches (often called "Basel IV") that aim to increase the risk sensitivity of the SA while reducing excessive variability in modelled risk-weighted assets. These proposals would further reduce differentials in capital requirements between the two approaches.

Nevertheless, the PRA and others recognise that more needs to be done to level the risk-weightings playing field. "This issue was identified by the Competition and Markets Authority in its report last year on competition in retail banking markets and it could potentially conflict with the PRA's secondary objective to support competition in financial services," says the British Bankers' Association (BBA).

The PRA's *Annual Competition Report 2016*, published last June, made a commitment to address the disparity in risk weights between the SA and IRB approaches, which was reiterated by Sam Woods, the BoE's deputy governor for prudential regulation, in last October's Mansion House speech. With February's CP3/17 consultation paper, the PRA is delivering on that commitment.

The PRA proposes to supplement its current risk-by-risk assessment with an overall assessment of the total level of capital needed for each lender, looking at capital requirements in the round rather than just using a simple sum-of-the-parts approach. The SA already uses business model analysis and peer reviews and, under the new proposals, would also take account of other factors, including to what extent existing methodologies can lead to smaller banks maintaining capital in excess of a prudent coverage of the risks faced.

Importantly, the PRA proposals would allow SA banks to make use of the capital requirement benchmarks calculated

> *The PRA recognises that more needs to be done to level the playing field*

from the risk weights used by banks employing internal models. According to Woods, "where this work shows the PRA can safely lower a bank's capital requirement, it will do so". He has said that this is an important step on the road to more effective competition in a safer banking system.

Allowing banks that want to migrate to IRB to use external data is an important step. Many banks seeking to move from the SA may not have statistically adequate internal data on either probability of default or loss given default (LGD), which are key inputs into IRB modelling. This lack of default data is exacerbated in a low interest rate environment in which there will be fewer stressed mortgage borrowers and, therefore, lower rates of default.

"The lack of available default data for newer entrants is a major barrier to their ability to build AIRB-compliant credit risk models, which would ultimately enable them to demonstrate that a lower capital requirement is appropriate,

> *A change in regulation would inject some much-needed competition into the UK market and be fairer*

and therefore be able to compete more effectively on a level playing field,"says Gillan.

Big data technologies, drawing on the Council of Mortgage Lenders' database, could help in aggregating external data bases and identifying their relevance to a particular lender's portfolio. "There's no doubt that big data will help lenders aggregate and prioritise external reference data," says the BBA.

If the PRA's proposals are adopted, they would go some way towards levelling the playing field in the UK mortgage market. "We hope that the policy implemented following the period of consultation reflects a more proportionate approach," says Gillan. "A change in regulation would inject some much-needed competition into the UK market and enable all banks to compete more fairly."

The BBA agrees on the direction of change but is cautious on the extent of the impact. "A change in the rules could increase competition, which is in the interest of UK borrowers, although the exact impact will depend on a number of factors," it says. For example, the degree of conservatism that challenger banks might overlay on calculations that rely on external data would have an effect. But new rules would allow challenger banks to rebalance their risk portfolios as they started to compete in lower LTV mortgages, which is likely to have a beneficial impact on their cost of capital.

Increased competition in the retail banking market would be good for both consumers and challenger banks. Hopefully it can be achieved without unintended consequences. ■

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