STATEMENT ON THE REGULATORY TREATMENT OF RETAIL RESIDENTIAL MORTGAGE LOANS UNDER THE HELP TO BUY GUARANTEE

The purpose of this statement is to describe the Pillar 1 capital requirements for loans protected under the Help to Buy: mortgage guarantee scheme (HBG) as set out in the relevant European legislation[1]. The regulatory treatment described here would be applicable to mortgage insurance schemes with similar contractual features.

This statement does not provide an exhaustive description of the prudential requirements for HBG loans, so firms are encouraged to review the EU legislation and, as necessary, seek independent advice to confirm that they meet all applicable requirements. In particular the Capital Requirements Regulation requires[2] firms to obtain a legal opinion on the effectiveness and enforceability of credit protection afforded a guarantee such as HBG. The PRA considers this requirement to be capable of being satisfied on the basis of a legal opinion obtained jointly by firms. Under HBG the Government guarantees a portion of the first losses, net of recoveries, on retail residential mortgage loans eligible for the scheme.

As a result of the first loss guarantee on HBG loans, the following securitisation positions are created:

- the guaranteed portion of an HBG loan generates an exposure to the Government as guarantor of the first loss on the loan; and
- the remaining part of an HBG loan is an exposure to the borrower the risks of which are retained by the participating lender.

The tranching of the credit risk of an HBG loan into these two positions will result in firms calculating Risk Weighted Exposure Amounts ('RWEA') in accordance with Article 234 and Chapter 5 of Title II of the CRR, and the definitions of securitisation and synthetic securitisation in Articles 4(61) and 242(11). Because the guarantee is provided on individual loans, each HBG loan will be treated as an individual set of securitisation positions.

The approach a firm uses for credit risk purposes for its UK retail residential mortgage loans - the Standardised Approach or the Internal Ratings Based (IRB) approach - will determine how a firm calculates capital requirements for HBG loans.

Firms using the Standardised Approach to credit risk for the underlying mortgage loans

Subject to meeting the significant risk transfer test (SRT) (see below), the concentration ratio approach set out in CRR Article 253 will apply for a firm using the Standardised Approach for UK retail residential mortgage loans when calculating RWEAs for its retained securitisation exposure to each HBG loan.

In the case of mortgage loans under the HBG scheme, the concentration ratio will be equal to 1 and the risk weight applied to the retained exposure would be equal to that which would apply to the underlying mortgage loan under the Standardised Approach in accordance with Articles 123 to 125 of the CRR.

The guaranteed portion of the loan would be treated as an exposure to the UK Government.

Firms using the IRB approach to credit risk for the underlying mortgage loans

For a firm using the IRB approach for UK retail residential mortgage loans, Articles 259 and 262 of the CRR will determine the risk weighting method used for the retained securitisation exposure. This is also subject to meeting the SRT test (see below).

The PRA's current approach to originators' use of the Supervisory Formula Method (SFM) for securitisation transactions is set out in LSS10/13. The PRA's proposed approach to securitisation under the CRR is set out in CP 5/13. The PRA considers it would not be practical for firms to acquire an external credit rating on their retained positions on each individual guaranteed HBG loan. Under the CRR, the PRA expects that firms using the IRB approach would use the SFM to determine the risk weight of the senior portion of HBG loans, given the impracticality of acquiring an external credit rating noted above.

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[1] Regulation (EU) No 575/2013 – the 'Capital Requirements Regulation (CRR) – and Directive (2013/36/EU) – the Capital Requirements Directive 4 – and which set prudential standards for UK banks and building societies that will apply from 1 January 2014.

[2] Articles 213(3) and 244(5)(d)

When applying the SFM, firms must calculate the IRB capital requirements for each individual HBG mortgage loan as though it had not been securitised as an input into the SFM equation: K_{IRB}[1]. Where the PRA has applied floors or adjustments to a firm's IRB parameters, or underlying elements of those parameters, for non-securitised UK retail residential mortgage loans the PRA would expect those floors or adjustments to be applied also for the purposes of calculating K_{IRB}. This would include the 10% floor to the exposure-weighted average Loss Given Default (LGD) of exposures that applies to retail residential mortgage loans under Article 164(4) of the CRR (in the case of loans not benefitting from guarantees from central governments). The PRA expects a firm's approach to applying the 10% LGD floor, and other relevant floors and parameter adjustments, for the purposes of calculating K_{IRB} to be consistent with its general approach to such floors and adjustments and to be applied consistently through time. The PRA intends to review the approaches in this regard in early 2015.

The guaranteed portion of the loan would be treated as an exposure to the UK Government.

5% vertical slice

Under HBG, participating firms are exposed to 5% of the first loss on a HBG loan. Given that firms retain the whole of the senior part of the loan, the PRA considers this to be equivalent to the firm holding a 5% 'vertical slice' of the underlying mortgage loan outside of the guarantee structure. The PRA expects firms to calculate the capital requirements for that part of an HBG loan as an exposure to the underlying mortgage loan using the IRB or Standardised Approach, as applicable.

The PRA expects the 5% vertical slice of each HBG loan outside the guarantee to be included in the calculation of the 10% LGD floor set out in Article 164(4) of the CRR.

Cap on payments under the guarantee

Under HBG, guarantee payments to participating lenders using the IRB approach are capped at 9% of total original principal balances of HBG loans written by that lender through the life of the scheme. The PRA expects the effect of the cap to be reflected in the prudential treatment of each individual HBG loan by appropriately limiting the protection recognised.

Maturity mismatch

Article 250 of the CRR sets out the requirements for adjusting RWEAs for synthetic securitisation under the Standardised and IRB approaches where there is a mismatch between the maturity of credit protection (the guarantee) and the securitised exposures.

Significant Risk Transfer (SRT)

Mortgage loans guaranteed under the scheme will be subject to the SRT requirements set out in CRR Article 244.

SRT: Standardised Approach

Under CRR Article 244(4), the PRA may grant permission to firms allowing them to not apply the mechanistic tests set out in CRR Article 244(2) when certain conditions are met.

The PRA is of the view that firms using the Standardised Approach in respect of their HBG loans would normally meet the conditions set out in Article 244(4) because the credit enhancement from the first loss protection applied to those loans is not fully reflected in the concentration ratio (that is, the amount of risk transferred will typically be greater than the amount of capital relief that would be available under the concentration ratio). The PRA is therefore minded to grant this permission to firms using the Standardised Approach in relation to all of their HBG loans, in which case applicant firms will not be required to notify each individual loan. The PRA may, however, subject the permission to certain conditions, specifically the firm's providing additional reporting on the HBG loans on a periodic basis.

SRT: IRB Approach

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[1] *'K_{IRB} ' in Article 242(4) of the CRR is defined as "8% of the risk-weighted exposure amounts that would be calculated under Chapter 3 [the IRB rules in the CRR] in respect of the securitised exposures, had they not been securitised, plus the amount of expected losses associated with those exposures calculated under that Chapter."*

The PRA is of the view that the conditions required under Article 244(4) to grant a permission would not be met for firms using the IRB approach for UK retail residential mortgage exposures. Therefore the tests set out in Article 244(2) of the CRR would apply for such firms for each HBG loan. In accordance with Article 244(2)(c) of the CRR the reduction in regulatory capital must be matched by a commensurate transfer of risk to third parties.

The PRA would otherwise require firms to post-notify each individual securitisation transaction in accordance with rule 4 of the Credit Risk Part (PRA Rulebook CRR Firms: Benchmarking of Internal Approaches and Credit Risk Instrument 2013). However, applying this notification requirement to each HBG loan would likely be too burdensome. Firms may apply for a modification of this rule in accordance with s. 138A FSMA so that they can notify the PRA of multiple HBG loans. As a condition for granting the modification the PRA may require periodic information on a firm's overall use of HBG in order to be sufficiently informed of the achievement of commensurate risk transfer in those cases.

Regulatory reporting

From 1 January 2014, the EU Common Reporting (COREP) framework will apply to firms' reporting of HBG loans.

The PRA expects firms to report the securitisation exposures relating to HBG on an aggregated basis in the COREP securitisation template, and will discuss the appropriate level of aggregation with firms and how to reflect it in the COREP templates. The PRA expects the 5% vertical slice of an HBG mortgage loan outside the guarantee structure to be reported as a retail residential mortgage exposure under the Standardised Approach or IRB approach template, as applicable.