

Positive Money response to CP16/22 – Implementation of the Basel 3.1 standards

Positive Money welcomes the opportunity to respond to the Prudential Regulation Authority's consultation on the implementation of the Basel 3.1 standards.

We are a not-for-profit research and campaigning organisation, working towards reform of the money and banking system to support a fair, democratic and sustainable economy. We are funded by charitable trusts, foundations and small donations.

A number of points made in this submission are also echoed in an additional [joint statement](#) from civil society stakeholders.

Key points

- We support the PRA's restrictions on the use of IRB approaches and all other measures that would constrain the ability of IMs to general lower capital requirements. We would encourage the adoption of the output floor in full.
- We would encourage higher risk-weightings for real estate exposures, particularly exposures materially dependent on cash flows generated by the property, as well as other non-primary residence homes. We oppose any exemptions that would allow lower risk-weightings for investors on a 'three property limit', and support the PRA taking a conservative approach to property valuations where real estate is used as collateral.
- We believe that there are a number of other relevant issues not addressed in the PRA's consultation paper. These include the potential for regulatory arbitrage between banks and non-banks, climate risk, as well as wider interactions with macroprudential considerations.
- Risk weights must be updated to reflect climate risk. We support the introduction of a 1250% risk-weight for investment in new projects incompatible with credible net zero pathways, as well as a 150% risk-weight for other fossil fuel exposures.

General comments

The PRA's implementation of Basel 3.1 must support a level playing field of higher standards across the UK banking system. Currently, larger firms appear able to underestimate credit risk with severe implications for both financial stability and competition.

We welcome the PRA's efforts to constrain the ability of IMs to generate lower capital requirements and would encourage the adoption of the output floor in full. We particularly favour a more conservative approach to real estate exposures.

We believe that there are a number of other crucial considerations that the PRA's approach to Basel 3.1 appears not to give due regard to. These include the potential for regulatory arbitrage between banks and non-banks, climate risk and wider interactions with macroprudential considerations.

The implementation of Basel 3.1 should also be considered in the wider context of the PRA's approach to regulating other financial institutions. The Solvency II package currently being considered effectively represents a considerable weakening of capital requirements for insurers, and as the PRA recognises, will significantly increase risk.¹ We are therefore concerned that divergences between the PRA's approach to Basel 3 and Solvency II could create opportunities for regulatory arbitrage, with insurers increasingly able to act as shadow banks, becoming conduits for investments considered risky under Basel without the appropriate capital charges.

We share concerns expressed by former Bank of England deputy governor Paul Tucker that UK regulators are failing to deal with the risks of shadow banking.² Therefore we believe that the PRA should be taking greater efforts to ensure equally strong regulatory standards across both banks and non-banks.

While the PRA's approach to Basel 3.1 is chiefly microprudential, it appears unclear from this consultation paper whether adequate consideration has been given to the wider macroprudential implications of the proposals, even if this may primarily be the concern of the FPC.

¹ [Twenty per cent higher chance of insurance firms collapsing due to Solvency II reforms, Bank of England tells Treasury Committee](#)

² [Bank of England accused of failures on shadow banking | Financial Times](#)

IRB approach

Q19: Do you have any comments on the PRA's proposed restrictions on the use of the IRB approach?

We share concerns that IRB approaches produce unduly low risk-weights. The significant fall in average risk weights among major UK banks since the global financial crisis rightly raises doubts about the adequacy of internal models (IMs).

We are similarly concerned that IMs confer undue advantages to larger firms, providing barriers for competition in the banking sector. We therefore support restrictions on the use of IRB, as well as constraints on the RWA benefits that IMs can provide.

Output floor

Q49: Do you support the scope and levels of application of the PRA's proposed output floor? Do you have any additional evidence on the potential impact of these proposals with respect to different activities or particular business lines?

Given our concerns expressed above about the unfair advantages enjoyed by firms able to use IMs, we support the adoption of the output floor in full.

We are however open to exceptions being made for mutual banks using IMs. This is because the nature of the mutual model incentivises more responsible approaches to risk than for publicly traded banks. Mutuals represent a positive banking model that are constrained by the current regulatory environment favouring large banks, which are able to raise capital cheaply on equity markets, and the overall safety and soundness of the financial system would be improved by mutuals' proliferation.

Real estate exposures

The favourable treatment of mortgage lending in Basel risk-weighting leads to structural distortions in the allocation of credit towards non-productive assets. While at first the allocation of credit may not seem like a matter for the PRA, it ultimately results in financial fragility by fostering the UK economy's reliance on the property market. A large volume of academic literature has studied this relationship between the growth of mortgage credit and weaker economic performance, and ultimately financial instability.³ Basel 3.1's continued favouring of unproductive assets such as mortgages relative to productive assets such as SME loans means that there is a tendency for debt to grow faster than the economy's ability to repay, to put it simply, with severe implications for financial stability.

³ See for example: <https://academic.oup.com/rfs/article-abstract/31/7/2806/4948788>, <https://www.nber.org/papers/w20501>, <https://www.ecb.europa.eu/pub/pdf/scpwps/ecbwp888.pdf>, https://www.esrb.europa.eu/pub/pdf/other/Credit_allocation_and_macro_economic_fluctuations.pdf, <https://www.rug.nl/feb/research/som-research-reports-2012-2022/som-research-reports-2014/14025-gem-def.pdf>

While lending secured against property may be considered safer in isolation, the systemic over-allocation of credit towards mortgages has damaged the real economy across many countries, including the UK's, and increased financial fragility.⁴

Furthermore, Basel weightings do not accurately reflect the high systemic liquidity risk of mortgage lending, which derives from the manner in which property becomes particularly illiquid during times of stress, making prices vulnerable to collapse.⁵ Therefore we would encourage higher risk-weightings for mortgages, particularly those secured against non-primary residence homes, on both microprudential and macroprudential grounds.

The proposed approach by the PRA seeks to increase some risk weightings for real estate, but this is not applied evenly and will do little to control the excessive mortgage lending and financial investment that has driven up UK house prices over the past fifty years.

In 2022, we commissioned a YouGov survey of 1,751 adults about strategies to manage the housing crisis. Two thirds (66%) of respondents agreed that the Bank of England should directly intervene to manage house prices, saying that they would “support the Bank of England being given a target to keep house price inflation low and stable, in the same way it does for consumer price inflation.” This is the case across all regions of the UK, and among supporters of all the main political parties.

Question 14: Do you have any comments on the PRA's proposed approach to risk-weighting real estate exposures?

1. **The expansion of UK mortgage lending has been a primary driver of UK house price rises.** Numerous empirical studies have identified credit as an important explanatory factor in explaining cross country differences in house prices, with one describing shifts in credit conditions as the “‘elephant in the room’ for economies with liberalised financial markets”.⁶ A detailed breakdown of the available research can be found on our website,⁷ with relevant studies including:
 - a. An OECD study of 19 countries between 1980 and 2005 that found that financial deregulation and an expansion of mortgage credit may have translated into increases in house prices by 30% – far more than other demand and supply variables.⁸
 - b. An International Monetary Fund (IMF) study⁹ of thirty-six advanced and emerging economies (including the UK) that found a “strong positive relationship between house price movements and household credit growth, also when controlling for the main fundamental drivers of house prices”. A 10

⁴ <https://academic.oup.com/ser/article/21/1/437/6413687#310567029>

⁵ [Breaking the Link between Housing Cycles, Banking Crises, and Recession | PIIIE](#)

⁶ Duca, J. V., Muellbauer, J. & Murphy, A. (2011). House prices and credit constraints: Making sense of the US experience. *The Economic Journal* 121, 533–551.

⁷ [Positive-Money-Report-Banking-on-Property-March-2022.pdf \(positivemoney.org\)](#) p30-33

⁸ Andrews, D. Sánchez, A. C. and Johansson, Å. (2011). ‘Housing markets and structural policies in OECD countries’. OECD Economic Department Working Paper 836, OECD, Paris, France.

⁹ IMF. (2011). ‘Housing Finance and Financial Stability—Back to Basics?’. *Global Financial Stability Report*, Ch. 3.

percentage point growth in mortgage credit as a percentage of GDP was associated with a 6 percentage point higher growth of real house prices.

- c. According to research from King's Business School, if foreign investment in the housing market in England and Wales had remained at the level it was in 2000, the price of the average home in 2014 would have been 19% lower than it actually was.¹⁰
2. **Managing the desirability of property as a financial asset, particularly to those other than owner-occupiers, is therefore essential to putting UK house prices on a more sustainable footing and reducing financial fragility.** UK property purchases have been made more desirable, to landlords and investors, than other forms of investment thanks to: the expectation of continued house price rises, low property tax rates (excluding council taxes, which are passed to tenants),¹¹ generous property tax write-offs,¹² and Capital Gains Taxes that are lower than the rate of income taxes.¹³ Consequently, mortgages have become increasingly attractive to investors: in 2021 over half of landlords had relied on Buy-to-let mortgages.¹⁴ This has contributed to the explosion in mortgage credit availability since the 1980s that has been a primary driver of house price rises in the UK as described above, and siphons potential investment away from the real economy and more productive activities.¹⁵ Easy access to mortgages also poses a threat to financial stability as well as competitiveness, as excessive lending towards property forms debt overhangs that increase beyond the economy's ability to repay. Managing excessive mortgage lending is therefore crucial to mitigating the impact financial conditions have on house prices, and ensuring home purchasing remains accessible for ordinary homeowners.
3. **Therefore we support, at a minimum, efforts to align risk weightings with international standards, as well as the PRA's overall attempt to increase the risk-sensitivity of SAs in regards to real estate.** Aligning risk weightings with the international system is a positive step to avoiding UK homes being seen as internationally desirable investment vehicles, as is this proposal's high level plan to enhance the risk-sensitivity of SAs.
4. **However, the proposed risk weights do not sufficiently capture the risks to financial stability and the wider economy posed by excessive mortgage lending, particularly to landlords and investors.** For example:
 - a. 3.153 Applying higher risk weightings for care homes and student accommodation could come with exemptions for public bodies and housing associations seeking to expand necessary local infrastructure. Similar could apply for social housing (3.171).
 - b. 3.164 We oppose the proposed exceptions that would allow lower risk weightings for investors with up to three properties. In light of our comments above, all loans to BTL landlords should face at least the 150% risk weight for exposures materially dependent on cash flows generated by the property.

¹⁰ Sá, F. (2017). 'The effect of foreign investors on local housing markets: Evidence from the UK'. CEPR Discussion Paper No. DP11658. Available [online](#).

¹¹ Lloyd, Ryan-Collins & Macfarlane. 2017. Rethinking the Economics of Land and Housing.

¹² [A quick guide to property development tax - Startups.co.uk](#)

¹³ [Capital Gains Tax: what you pay it on, rates and allowances: Capital Gains Tax rates - GOV.UK \(www.gov.uk\)](#)

¹⁴ [English Private Landlord Survey 2021: main report - GOV.UK \(www.gov.uk\)](#)

¹⁵ [The housing wealth trap - Positive Money](#)

- c. 3.166 Proposals are made to introduce more risk-sensitive risk weights for residential real estate exposure based on the loan-to-value ratio. This favours capital-rich investors in gaining access to loans, penalising first-time buyers and less wealthy households.

In addition, further adjustments may be suitable:

- d. Applying the highest risk weightings for any categories of mortgage borrower who will not occupy the property as a primary residence, including borrowers who are resident overseas. As outlined above, we suggest that the proposed real estate risk weighting fail to address the macroprudential risks associated with excessive lending towards UK property. This is particularly important in the case of overseas non-residents - we note that the proposed change to the simpler-regime 'Domestic Activity Criterion', to allow firms to claim mortgages provided to overseas entities as domestic activity, could increase incentives for UK firms to provide lending secured on UK properties to overseas borrowers.
- e. Lower risk weightings could be specified for First Time Buyers, local authorities, housing associations and community land trusts to encourage growth in these sectors.

Q13: Do you have any comments on the PRA's proposal that the value of the property shall be measured at origination and on the proposed approach to determining origination value? Do you have any comments on the proposed prudent valuation criteria?

- 5. **We share the PRA's concern that the way in which property is valued as collateral can lead to excessive cyclicality in values. We therefore support a more conservative approach to property valuations when real estate is used as collateral, not only on the basis of microprudential risk, but because this could also help dampen excessive investment in property, which inflates house prices.** This consultation proposes to set the valuation of real estate collateral as being that of the valuation obtained when a new mortgage loan is issued, i.e. 'at origination'. Assuming that property prices continue rising, and major changes in property value are not claimed (3.157) this is likely to reduce valuations. However, this does not adequately redress the issue that those with multiple properties will find it easier to access mortgages for further real estate purchasing, raising prices (see 5).
- 6. **However, we also note that Basel 3.1 contains little that meaningfully reduces the use of real estate as collateral.** The macroprudential risk of the widespread allocation of bank credit to mortgage lending is extremely high, as outlined above.

Climate risk

As the PRA recognises, the Financial Services Act 2021 requires the PRA to have regard to the government's net zero target when making Capital Requirements Regulation (CRR) rules. Furthermore, HMT's recommendation letters to the Prudential Regulation Committee

clarify that regulators must have regard for delivering net zero, as part of the government's economic strategy.

While the PRA claims that "The Basel 3.1 standards were not designed to include specific climate risk-related measures", it is important that capital rules are calibrated to reflect climate risks, particularly the high risk associated with fossil fuel exposures.

The Bank of England's own Climate Biennial Exploratory Scenario (CBES) found that climate change could cost UK banks more than £340bn in a scenario in which climate action is delayed.¹⁶ Research has shown that a fossil fuel-driven banking crisis in the next decade could cost over £4 trillion in public bailouts.¹⁷ While these exploratory exercises and studies help gauge the potential scale of the financial system's exposure to climate risk, it is essential to recognise that such risks are uniquely complex and cannot be accurately quantified or 'efficiently' priced into market activities.¹⁸ In its report on 'Climate Risks and the Regulatory Capital Framework', the Bank of England recognised much of this complexity, stating that climate risks have "unique characteristics", including "non-linearities and feedback loops", that make them hard to predict and that may require more "forward looking" tools.¹⁹ This also applies to wider environmental risks beyond climate, such as those associated with biodiversity loss, water scarcity, and ocean acidification.²⁰

Therefore, to avoid potentially catastrophic outcomes, financial policymakers must adopt a precautionary approach to environment-related risks.²¹ Persistent fragilities in the banking system evidenced by the collapse of SVB and emergency rescue of Credit Suisse, as well as the fragility of non-banks illustrated by pension funds in Autumn 2022, make this even more pressing. As a central pillar of a precautionary approach to prevent financial instability resulting from risky fossil fuel financing, the Bank of England should adapt prudential tools to account for environmental risks.

As a first step, a 1250% risk weight should be applied to exposures to new fossil fuel exploration, exploitation, and production. This is frequently referred to as the 'One for One' Rule,²² as it requires that for each pound of financing to new fossil fuels, banks and insurers should have a pound of their own funds held liable for potential losses. This would ensure that investments incompatible with the IEA's pathway for net zero, which will be severely affected by the transition, are funded wholly by banks' own capital, rather than putting the public's deposits at risk.²³ Furthermore, risk weights on exposures to existing fossil fuel

¹⁶

<https://www.bankofengland.co.uk/stress-testing/2022/results-of-the-2021-climate-biennial-exploratory-scenario>

¹⁷ [Sunrise Banking on Bailouts report, 12 Jan 2021](#)

¹⁸ <https://positivemoney.org/2019/10/climate-risk-vs-uncertainty-in-financial-policymaking/>

¹⁹ Bank of England [report](#) on climate-related risks and the regulatory capital frameworks, Monday 13th March 2023

²⁰

https://www.ucl.ac.uk/bartlett/public-purpose/sites/public-purpose/files/final_kedward_et_al_nature-related_finance_18_aug.pdf

²¹ <https://www.sciencedirect.com/science/article/pii/S092180092100015X>

²²

<https://www.finance-watch.org/press-release/joint-press-release-call-for-one-for-one-prudential-capital-requirements-on-fossil-fuel-financing-to-prevent-an-economic-crisis/>

²³ <https://www.finance-watch.org/publication/breaking-the-climate-finance-doom-loop/>

projects should be set at 150%, consistent with the Basel framework's standardised approach to high risk exposures.²⁴ Subsequently, as the PRA deepens its understanding of climate risks, it should also develop an approach to calibrating risk weights for other types of assets that are exposed to high levels of transition and physical risk.

We note that central banks in the Network for Greening the Financial System,²⁵ including the European Central Bank,²⁶ are considering the use of climate-calibrated capital requirements.

²⁴ https://www.bis.org/basel_framework/chapter/CRE/20.htm

²⁵ Network for Greening the Financial system, [Guide for Supervisors Integrating climate-related and environmental risks into prudential supervision](#).

²⁶ European Central Bank. [The challenge of capturing climate risks in the banking regulatory framework: is there a need for a macroprudential response?](#)