

The Capital Treatment for Open Market Homebuy

Extract from a letter by the Financial Services Authority to the Council of Mortgage Lenders of 20 September 2006

Capital treatment

Based on the submissions of product providers and our discussions with the Council of Mortgage Lenders and the Department for Communities and Local Government it is our view that the Homebuy Loan is capable of being made available as one 'mortgage' product comprising two elements; a conventional mortgage loan and an 'equity' loan.

We propose accordingly to allow the entirety of the exposure to be treated for capital purposes as a 'mortgage' product where the following conditions are met:

- Both elements of the product are secured on the same property and cannot be held independently of one another except in circumstances where the 'equity' element has been redeemed early;
- The 'mortgage' element and the 'equity' element must have the same redemption date at origination and the 'mortgage' element must not be redeemable without the 'equity' element also being redeemed. Failure by the borrower to redeem the 'equity' element when the 'mortgage' element is redeemed or at the maturity date gives the provider legal recourse to the 'borrower' for the value of the equity loan which should be no less than the amount provided by the firm in respect of the 'equity' element.
- Internal risk measurement and management should be consistent with the provision of a single 'mortgage' product. Those elements of the product regarding pricing, documents, payments and defaults should reflect this.

Where these conditions are satisfied we propose to treat the Homebuy product in line with a conventional mortgage product under both the current and future regime. This treatment would be as follows

Current regime

- IPRU (Bank) Chapter BC 3.2.5 and Annex 1B of IPRU (BSOC) Chapter 1, Solvency allows Banks & Building Societies to risk weight exposures to residential mortgages at 50%. This applies to the total exposure and does not require a Loan to Value (LTV) ratio to be calculated providing the mortgage is fully secured.

Future regime

- For exposure to mortgage products up to the amount of 80% LTV the appropriate risk weighting is 35% for the Standardised Approach. (see BIPRU Section 3.4.56 ff.)
- The remaining 7.5% (75% + 12.5% - 80%) which exceeds the LTV threshold of 80% can be risk weighted either as a retail exposure at 75% if it is included in the retail aggregation calculation or alternatively if firms do not wish to include the excess 7.5% in their retail aggregation then the default position of a 100% risk weighting for 'other exposures' would be applicable.
- For exposures to mortgage products under the IRB approach, firms will be entitled to calculate the risk weights using their own estimates.

***Please Note:** Although the letter extract was published by Communities and Local Government, the content, findings and recommendations are those of the author and do not necessarily represent the views of the department*