Analysis

Housing loan risk weights affect banks' capital adequacy

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Risk weights help to establish each bank's minimum own funds relative to lending, ensuring the bank's ability to cover the related credit risk. The risk weight calculation method chosen by the bank may have a significant effect on capital requirements and ultimately on the price of credit. A harmonised calculation of housing loan risk weights would support fair competition between banks.



Two methods for calculating risk weights

Banks can use the **Standardised Approach or the Internal Ratings Based Approach (IRB)** for calculating risk weights. In the Standardised Approach the housing loan risk weight is currently a fixed 35%.[1] In the IRB Approach, banks use their own credit loss parameters for calculating risk weights. In Finland, average risk weights of banking groups using the IRB Approach vary between 6% and 13%.

If banks' housing loan risk weights need to be changed, the supervisor has various alternatives available. In the IRB Approach, the Financial Supervisory Authority can change the minimum LGD (Loss Given Default) parameter that significantly affects the risk weight, should this be called for by likely property market developments and any other relevant indicators.[2] The competent authority must periodically assess whether the minimum LGD values for exposures secured by residential and commercial immovable property are appropriate. The supervisor must report all its changes in minimum LGD levels to the European Banking Authority (EBA). EBA will then publish the new values.

A Member State can also impose stricter than minimum prudential requirements for credit institutions to prevent macroprudential or systemic risk.[3] However, the decision-making process

in order to do this is quite complicated, and the threshold to use macroprudential tools is high.[4]

The authorities may also change the fixed housing loan risk weights referred to in the Standardised Approach.[5] The supervisor may increase the risk weight largely on the same basis as with internal models. In this case, too, the supervisor notifies EBA about the changes and the related criteria. EBA then publishes the risk weights and criteria, and the supervisor confirms them.

Methodologically changes in risk weights can be implemented more clearly in banks applying the Standardised Approach than in banks using internal models. In the Standardised Approach, the risk weight itself is changed, whereas in the case of internal models the minimum value of a parameter (LGD) based on the bank's own material must be adjusted. However, the change of a value of one parameter in order to achieve a certain risk weight affects the operating principles of the model.

Harmonisation needed

In practice, the choice of calculation method significantly affects the size of a bank's average housing loan risk weights. The housing loan risk weight of banks using the IRB Approach averaged 7% at the end of 2014, while the corresponding value of banks applying the Standardised Approach is a fixed 35%. As the proportion of housing loans calculated on the basis of internal models was more than 60% in Finland's domestic banking sector at the end of 2014, the use of internal models has a considerable effect on the formation of the capital requirement of banks. In future this effect will continue to grow, as new banks are granted permission to use the IRB Approach in their capital requirement calculations. The importance of risk weights in curbing housing credit is elaborated in the article 'Tightening regulation has a limited impact on loan margins'.

Use of different kinds of calculation methods for establishing housing loan risk weights may lead to unequal treatment of banks in capital requirement calculations and the pricing of housing loans. However, the risk profile of housing loans is quite uniform and at national level there are hardly any differences in loan risks. Harmonised calculation of housing loan risk weights would support fair competition between banks. In addition, the use of risk weights as a macroprudential tool would be facilitated if banks were to apply a harmonised method (e.g. the Standardised Approach) for capital requirement calculations. At present, the Basel Committee on Banking Supervision is considering a change through which a lower limit for credit risk weights would be set for banks' internal models. In line with what has been said above, such a reform would improve the comparability and uniformity of calculation methods. The reform would, however, require a

change to the EU Regulation.

Notes

1. The risk weight can be set at 35–150%. ↑
2. See article 164 in the Capital Requirements Regulation. ↑
3. See article 458 in the Capital Requirements Regulation. ↑
4. The decision must be notified to the European Parliament, the Commission, the Council, the European Systemic Risk Board (ESRB) and the European Banking Authority (EBA); in addition, quantitative and qualitative evidence of the matters mentioned in the Regulation must be submitted. The ESRB and EBA provide their opinions on the matter in question to the Council, the Commission and the Member State concerned. In the absence of a Commission proposal within one month, the Member State concerned may immediately adopt draft national measures. The Council must decide on the proposal by the Commission within one month after receipt of the proposal and state its reasons for accepting or rejecting the draft national measures. ↑

Keywords

banking regulation, housing markets, risk weights for housing loans, risks