Analysis

# Regulation has a limited impact on margins

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AUTHORS



Jukka Vauhkonen
Senior Adviser



Jyrki Haajanen



Hanna Putkuri
Adviser

The foreseeable tightening of bank capital requirements will only marginally add to bank costs and, by extension, to loan margins. The other side of the coin is that the most important tool at the disposal of the Financial Supervisory Authority for preventing threats to stability from excessive credit growth – the countercyclical capital buffer requirement – may turn out to be a more ineffective macroprudential instrument than hoped for. Regulation of minimum risk weights for housing loans is likely to be a more effective tool for reining in excessive growth in lending for house purchase.



## Costs exaggerated

It has often been claimed that the ongoing tightening of bank capital requirements will lead to substantially wider bank loan margins. Calculations made at the Bank of Finland suggest such claims are exaggerated.

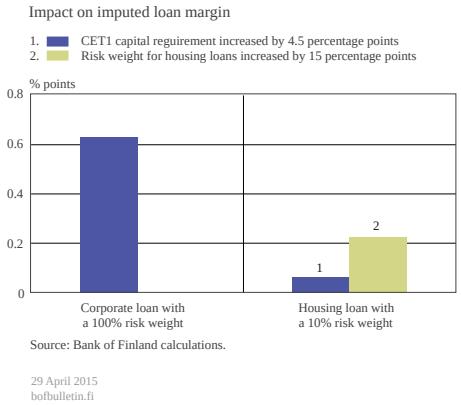
Tightening capital requirements will increase funding costs for banks, as banks will need to finance a larger part of their lending by a relatively expensive form of funding – equity – rather than cheaper forms of funding, such as deposits and long-term debt securities. Banks will seek to pass at least a portion of their higher costs on to the prices of loans and other services they offer. However, contrary to what we might judge from the public debate, the costs on banks from the additional capital requirements will be relatively low.[1]

## The higher-risk the loan, the greater the impact

Stricter capital regulations will have the strongest impact on high-risk loans, for which the imputed bank capital requirement in the form of own funds is the highest.[2] Raising the Common Equity Tier 1 (CET1) capital requirement by 4.5 percentage points – which corresponds to the foreseeable increase in the capital requirement for the largest Finnish banks from the level of 2014[3] – would increase the imputed margin on a particularly high-risk unsecured corporate loan

by a maximum of just over 0.6 of a percentage point (Chart). By contrast, the margin on a housing loan estimated to carry a limited amount of credit risk would increase by only about 0.06 of a percentage point.[4]

Chart 1.




The calculation underlying this analysis (Chart) assumes that the bank will pass on its higher funding costs in full to the margins on new customer loans.[5] Another assumption in the calculation is that the bank's requirement for return on equity (cost) will be high, at 15% a year. Growth in loan margins will remain markedly lower than in this analysis if keen competition between banks prevents them from widening their margins in full, if the required return on equity is more moderate than assumed, if the cost of debt financing is higher than assumed (1%) or if the loan applicant provides strong collateral.

## Lending for house purchase can be reined in by setting higher risk weights

The outcome of the calculation is comforting for those who have feared that tightening regulation will unreasonably raise the price of bank loans. The other side of the coin is that the most important macroprudential tool available to the Financial Supervisory Authority (FIN-FSA) – the countercyclical capital buffer requirement set on banks in a strong credit cycle – may turn out to be less effective than hoped for, in particular for curbing what is considered to be excessive growth in lending for house purchase. Even if the countercyclical capital buffer requirement were set at its maximum size of 2.5%, this would only have a limited impact on bank costs and, by extension, on housing loan margins and demand.

Bank capital requirements can also be influenced by regulating the minimum risk weights for lending secured by residential real estate, as used in capital adequacy calculation, on the basis of

considerations relating to financial stability.

In regulating minimum risk weights, the authorities effectively in part restrict the use of banks' internal credit risk models in the determination of bank capital requirements. The justification for setting higher risk weights could be, for example, that banks' credit risk models fail to lay adequate emphasis on financial stability threats from excessive growth in lending for house purchase.

The higher the risk weight assigned to a loan is, the more own funds a bank is required to hold to cover risks related to the loan and the more expensive the calculated funding of the loan is for the bank. Raising the risk weight for a housing loan by 15 percentage points would increase the imputed margin on the loan by a good 0.2 of a percentage point, on the assumption that the CET1 capital requirement for the bank (10.5%), the required return on equity (15%) and the assumed price of debt financing (1%) remain unchanged (Chart).

Consequently, regulation of minimum risk weights for housing loans is likely to be a more effective macroprudential tool than the countercyclical capital buffer requirement in mitigating stability threats posed by lending for house purchase. (For other tools, see 'A broader set of tools needed to prevent financial crises'). In addition, setting higher risk weights for housing loans has no direct imputed impact on the prices of other bank loans, thus helping to reduce the undesired effects of macroprudential policy on other bank lending.

## Notes

1. See Vauhkonen, Jukka (2015) Tarina makkaranteosta ja lainamarginaaleista ('A story of sausage manufacturing and loan margins'). Bank of Finland blog, 26 January 2015. ↑
2. At the current minimum 10.5% level of the Common Equity Tier 1 (CET1) capital ratio, the amount of equity capital a bank is required to allocate against a corporate loan assigned to the 100% risk weight category is 10.5% of the exposure. For a housing loan with a risk weight of 10%, the equity requirement is 1.05% of the exposure. ↑
3. A capital conservation buffer requirement of 2.5% for all banks entered into force at the beginning of 2015. From the beginning of 2016, an additional capital requirement of 2% at most may be assigned to banks, based on their systemic importance. ↑
4. The impact of the tightening of capital requirements on growth in loan margins is linear with respect to the loan's risk weight. ↑
5. For housing loans, margin increases are only possible in connection with new loan agreements. This may add to pressures to raise margins on new loans, relative to the calculation. ↑

## Keywords

countercyclical capital buffer requirement, loan margins, macroprudential instruments, risk

weights for housing loans