Mortgage loan risk weights go up (and down?)

Banks that provide mortgage loans can be subject to more or less risk depending on for instance developments in house prices and house shortages in countries or cities. This means they need to hold more financial buffers or less financial buffers depending on the risk that the loan will not be repaid in full, which shift in prudential buffer demands in turn affects housing affordability for most buyers (and thus stimulates or dampens the housing market). EBA is now consulting on the 'regulatory standards' on varying the risk weighting for mortgage loans for both homes (residential property) and commercial properties such as shops and offices due to such financial stability considerations. The consultation paper is fostering this discussion very helpfully, but still has some severe shortcomings if it were to become law in this way, one of them is that it only deals with the increase of the risk weight, not with the decrease thereof, the effect of this information on the market, nor the changes in prices and risk over time. Another concern is the lack of clear rules on the timing these supervisory interventions in the financial cycle, which is the subject of a separate comment.

The headline risk rate for immovable property backed loans in the standardised approach to credit risk is that they should be risk weighted at 100%. This headline risk rate is, however, only used if some rather lenient criteria set by the CRR are not fulfilled. If sufficiently backed by qualifying homes, shops or offices the risk weight is sharply reduced (to 35 or 50 %). For the internal model based approach, there is an equivalent possibility to reduce or increase the LGD factor. The result is that banks normally only have to hold a reduced amount of financial buffers on residential and commercial types of mortgage loans. The only exception is if these criteria on the relative value of the collateral to the loan are found not to be fulfilled, and – and this is the subject of the consultation – when supervisors indicate that the reduction in perceived risk is not opportune at that moment in time, or even demand an additional slice of capital by increasing the risk weighting for commercial and residential mortgage loans to up to 150%.

Lets leave aside that the definitions of the terms used are as clear as tar (of the type of definition that residential property means a property that is a residence) and thus highly likely to be moulded not only to local practices but also to the lowest risk requirements. Lets also leave aside that if the supervisors set a high risk weight of 150%, it might be miraculously decided by the bank that the collateral is no longer sufficient, in which case the back-up risk weight of 100% will start to apply in accordance with the badly worded CRR provisions. Lets focus instead on the good intention that sometimes it would be good to require more capital, and sometimes less, for the good of the immovable property market and of the individual mortgage providers active in it.

The 150% risk weight is actually not new. It existed also in previous versions of the capital requirements directives, but was one of those territories that sounded good in theory but in practice were not used. In the depths of the subprime crisis, these levers gained new attention, and even a modicum of followers. For the standardised approach, some member states have now introduced stricter requirements on the lowest risk weighting, and some member states increased the risk weighting to 100% (none yet to the maximum of 150%). For the internal model based approach, only Norway (which is outside of the EU but covered by the CRR provisions under the EEA treaty) has used the possibility to increase the LGD factor in the internal model approach to credit risk (though other supervisors, however, may have done this too in an ad hoc manner as part of the model approval process). This is one of the macro/micro prudential levers that directly impact on the banks' capital requirements for mortgage loans, and thus on the property market in specified regions (either in a whole country like Greece, or just in overheating segments such as London or Amsterdam). The weird thing is that the proposed regulation only addresses the 'when should the requirement go up' question, and ignores the equally important 'when and how should the requirement go down'.

Even though this tool formally addresses only the capital position of individual banks, it applies to each domestic and foreign bank that is active in a specific property market, and thus will impact – intentionally it appears – on market prices in that area, by increasing or decreasing mortgage availability and interest rate levels. Hopefully, a similar restriction will apply to non-bank mortgage providers, though how this is ensured for specialised institutions or e.g. insurers is equally not addressed in the CRR or consultation paper. If the risk weight change might even potentially be a market-moving event, it is as important to give clarity on when the risk weight percentage or LGD should go down as on when it should go up. If this is not immediately clear from the new contemplated laws, the supervisor will join monetary authorities in their catch 22 of never being able to increase the interest rates if the only thing holding up market prices and holding back a recession is the fact that the market does not expect such an increase in interest rates. That the monetary interest rate dilemma relates also to bond and other financial instrument prices instead of – like this specific instance of mortgage loan risk weighting – only impacts on house prices and affordability does not really matter. If the risk weight is stuck at either a high or low value due to unclear criteria and potential market moving impact, it becomes useless as a macro economic and micro prudential lever.

In addition, the proposed rules should be clear on how supervisors should determine when the risk requirement goes up, but also how they clarify to the market when it certainly will go down again, and how gradual that decline will be. As market prices in the defined segment will be impacted – at least if they are intended to be useful – both by the decision to go up and by the decision to climb down (by reducing or increasing the exposure of the banks to that segment, and making new mortgage loans more expensive or cheaper) in a parallel to the insider information rules the obligatory decision-path and the communication plan of the supervisor involved should be very clear indeed. The consultation paper is silent on the communication plan that should have accompanied it, which is a serious defect on any issue that will and should impact overheating or collapsing housing markets.

To be fair, EBA’s drafting problems derive in part from unclear or one sided drafting of the CRR itself, which focuses solely on the going up variety, and ignores cross-sector and insider-information type concerns. Perhaps the attention of prudential supervisors and housing market organisations could have been better asked for and used at the time of drafting of the related CRR provision, which now contains pitfalls (what is the impact on the bank’s profitability, on their market share compared to other providers, why is there only a level playing field between banks on a specific approach, and not between banks on different approaches, and would a gradual build up and decrease not be better than the sharp cliffs now envisaged, and why do the increases not impact immediately on new mortgage loans, alongside a gradual build up for the existing mortgage loan portfolio?). And what should be the impact on the interest rates agreed in the existing loan portfolio, and is this a public policy concern (which it might well be if it impacts on the financial health of house owners), or is it an issue that can be left to banks (by introducing an additional component into their contractual interest rate calculation and adaptation).

In short, even within the boundaries of the sketchy provisions in the CRR, the consultation paper could be helpfully improved by filling in some of the blanks on adjusting these risk weight provisions both down and up, and on cross-sector cooperation as well as good communication. In an area as important as housing markets, leaving this to national discretion or to market participants may not be the best course. In addition, the related CRR provisions might be adjusted to improve their effectiveness.

Also see:

- The separate comment on timing these supervisory interventions
- Art. 124-126 CRR
- Art. 128.2 sub d CRR
- Art. 164-166 CRR
- EBA consultation paper EBA/CP/2015/12 of 6 July 2015 on determining higher risk-weights,
- EBA overview of notifications on 124 and on 164 CRR
- EBA Q&A 2014-1214
- EU Banking Supervision, chapter 6.2, 8, and 16.6.