

## SPECIAL ANALYSIS

# Higher Risk Weight Floor for Mortgages

**Concern about the historically high level of household debt in Sweden has prompted the Swedish Financial Supervisory Authority, Finansinspektionen (FI), to announce an increase in the risk weight floor for mortgages from 15 to 25 per cent, probably in 2014. The move is intended primarily to enhance banks' resilience to systemic risks in the financial system. It may also have repercussions on demand, as banks may pass on the costs associated with the rule change to mortgage borrowers. Such a scenario would normally trigger a monetary policy response to counter the dip in demand, and the net effects are expected to be limited. FI's announcement of higher risk weights for mortgages nevertheless raises interesting questions about the scope of its mandate for macroprudential supervision.**

### **NEW RISK WEIGHTS FOR MORTGAGES REFLECT MORE THAN JUST THE CREDIT RISKS IN INDIVIDUAL BANK EXPOSURES**

Banks' capital adequacy is based on the capital requirements for different assets being allowed to vary according to an asset's inherent risk. This differentiation of capital requirements is achieved through risk weights, such as those for mortgages. The risk weight for mortgages is therefore intended to reflect the risk in banks' lending against residential property and so ensure an appropriate capital base for this class of asset.

The idea behind different capital requirements for different asset classes is to limit risk-taking at individual financial institutions. The risk weight floor introduced by FI in May 2013 was duly motivated by higher risk weights better reflecting the credit risks in banks' own mortgage exposures and took account of the upcoming Swedish implementation of the international Basel III rules. Previously, the risk weights were based on historical credit losses and averaged around 5 per cent for several of the largest players.

The recently announced increase in the risk weight floor for mortgages from 15 to 25 per cent, on the other hand, comes under FI's mandate for macroprudential supervision, as the move is motivated more by higher systemic risks than by increased credit risks in individual institutions' mortgage expo-

asures.<sup>25</sup> This means that the measure has been weighed against other available macroprudential tools, such as higher countercyclical capital buffers. One key argument for raising the risk weights rather than introducing larger countercyclical capital buffers is that the latter would impact more widely on banks' lending and could be expected to put an unwanted damper on lending to firms.<sup>26</sup>

#### **EFFECTS ON MORTGAGE RATES DEPEND ON SEVERAL FACTORS**

Higher risk weights mean that banks' financing of a given loan will require more equity. Adapting to the new rules will therefore mean that banks' capital costs will increase, as loan financing is cheaper than equity financing in practice.<sup>27</sup> This applies even though the reduction in loan financing can be expected to lead to greater creditworthiness and somewhat lower funding costs. The cost of adjusting to the higher risk weights for mortgages will be distributed between banks' owners and mortgage borrowers according to how the rule change impacts on banks' required rates of return. A lower required rate of return due to lower risk for shareholders should mean that banks' owners bear part of the cost.

In the shorter term, it is perhaps more likely that the required rate of return will not change, and that the entire cost will instead be passed on to mortgage borrowers. A simple calculation indicates that this would push up the total interest cost for mortgage borrowers after tax allowances by almost 0.2 percentage points.<sup>28</sup> In practice, however, it is very difficult to predict how banks will adjust lending rates to the announcement of higher risk weights for mortgages, partly because this will also depend on the extent to which banks currently fulfil upcoming capital requirements.

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<sup>25</sup> This means that the risk weights cannot formally be increased until the rules on macroprudential supervision are in place, which is expected to be in spring 2014, but banks' adjustment to the new rules will probably begin before that.

<sup>26</sup> For a discussion of tools for macroprudential supervision, see "Creating a Swedish toolkit for macroprudential policy", *Riksbank Studies*, November 2012, Sveriges Riksbank.

<sup>27</sup> The state subsidises loan financing through deposit guarantees, tax-deductible interest, etc.

<sup>28</sup> The calculation assumes an unchanged required rate of return of 15 per cent after tax and an unchanged funding cost of 3 per cent.

## PREVIOUS STUDIES SUGGEST HIGHER CAPITAL REQUIREMENTS HAVE MINOR CONSEQUENCES FOR THE REAL ECONOMY

Previous studies by the likes of the Bank for International Settlements (BIS) suggest that higher capital requirements have a certain negative impact on GDP in the short term.<sup>29</sup> In autumn 2010, the Riksbank estimated that a 1 percentage point increase in banks' capital over a four-year period would cause interest margins on lending to rise gradually by around 0.1 percentage points.<sup>30</sup> The estimation of how higher lending rates then impact on the real economy is based partly on the Riksbank's general equilibrium model RAMSES. Higher lending rates put a damper on demand growth and elicit a monetary policy response such that the repo rate is around 0.05 percentage points lower after 18 quarters. Overall, however, GDP at this point is still around 0.1 per cent lower than in a base scenario with unchanged capital requirements.<sup>31</sup> In the absence of any monetary policy response, GDP will instead be 0.2 per cent lower.

The recently announced increase in risk weights entails a targeted increase in capital requirements for residential mortgages in the region of 1.5 percentage points.<sup>32</sup> Since mortgages account for less than a third of banks' total lending,<sup>33</sup> this suggests that the overall effects on lending rates and the real economy can be expected to be limited. This applies even though the implementation period will probably be shorter than in the calculations above.

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<sup>29</sup> See "Assessing the macroeconomic impact of the transition to stronger capital and liquidity requirements", BIS, December 2010. Another working group under the Basel Committee studied the long-term consequences for the real economy of capital requirements being raised by 1 percentage point and estimated the net effect in the long term to be an increase in GDP of 0-2 per cent – see "An assessment of the long-term economic impact of stronger capital and liquidity requirements", BIS, August 2010.

<sup>30</sup> This assumes that banks pass on the cost to households and firms in line with historical pricing behaviour. See also the article "The effects of Basel III on macroeconomic development" in *Monetary Policy Report 2011:1*, Sveriges Riksbank.

<sup>31</sup> The estimated effect on GDP is in line with the estimates presented in the BIS study. The Riksbank's time-series model results in a slightly greater effect, as do the time-series models used in the BIS study. See also the article "The effects of Basel III on macroeconomic development" in *Monetary Policy Report 2011:1*, Sveriges Riksbank.

<sup>32</sup> This calculation assumes that the minimum requirement for the capital base ratio is 15.5 per cent. See also *Risk weight floor for mortgages*, Finansinspektionen, November 2012, and the box "Minimum requirement for the banks' capital if risk weights for Swedish mortgages are raised" in *Financial Stability Report 2013:2*, Sveriges Riksbank. The higher risk weights for mortgages mean that the capital requirement for mortgages rises by  $((0.25 \times 0.155) - (0.15 \times 0.155)) \times 100 = 1.55$  per cent.

<sup>33</sup> See *Bank Interest Rates and Lending 2013:2*, Finansinspektionen.

### HOW FAR DOES THE MANDATE FOR MACROPRUDENTIAL SUPERVISION EXTEND?

FI's decision to increase the risk weight floor for mortgages under its mandate for macroprudential supervision raises some interesting questions concerning the interpretation of the mandate for macroprudential supervision and the implications this may have for other authorities.

FI's *microprudential* supervision aims to ensure individual financial institutions' resilience to credit losses. Its *macroprudential* supervision is intended to play a complementary role and strengthen banks' resilience to systemic risks. These risks can be seen as the negative externalities for the financial system that result from various events in the macroeconomy, such as a fall in house prices, and ultimately threaten financial stability. To identify appropriate instruments to counter systemic risks, FI therefore needs to take a position on the origins of systemic risks.

FI takes the view that, while the risk of banks suffering heavy credit losses on mortgages is currently small, it is impossible to rule out the possibility of, for example, a fall in house prices increasing the risk of credit losses on banks' lending to non-financial firms, with this impacting in turn on financial stability.<sup>34</sup> From this angle, the principal origin of systemic risk is not so much in the credit risks associated with mortgages as in the credit risks associated with lending to non-financial firms. If FI's primary concern is financial stability, this scenario would actually therefore motivate higher risk weights for business lending. High risk weights for mortgages imply instead that lending to non-financial firms is relatively cheaper for banks to finance, and the risk weights therefore no longer reflect the overall credit and systemic risk associated with the specific asset class.

In choosing higher risk weights ahead of higher countercyclical capital buffers, FI states that the latter would impact more widely on lending and risk pushing up interest rates on business lending.<sup>35</sup> To the extent that this reflects a stabilisation policy

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<sup>34</sup> This is because, in this scenario, households may repair their balance sheets by making larger repayments and reducing their demand, which could lead to increased credit losses at non-financial firms and so impact on financial stability. See also *The Swedish Mortgage Market 2013*, Finansinspektionen, July 2013.

<sup>35</sup> See *How FI can decrease the risks inherent in household debt*, Finansinspektionen, November 2013.

agenda, this can be seen as a broadening of the mandate for macroprudential supervision.<sup>36</sup>

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<sup>36</sup> A decision to increase the risk weights for lending to non-financial firms could put a damper on lending to these firms in the short term and so have undesirable effects on macroeconomic development in an economic climate where resource utilisation in Sweden is low.