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Dear all,

Please find attached two blogs on the issues raised by your consultation paper on mortgage loan risk weighting, which appeared on www.prudentialsupervision.eu on 4 and 5 October 2015. I trust you will find the comments and suggestions made there helpful in the finalisation of the standards.

If you have any questions, please do not hesitate to contact me.

Best regards,

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Prudential Supervision

4-10-15

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.

5-10-15

Variable mortgage risk weighting - Procyclical or anticyclical timing?

Increasing mortgage loan risk weights in a depressed property market is likely to be procyclical, as would reducing risk weights in booming property market. Strangely, this procyclicality appears to be acceptable under the contemplated EBA standards on adjusting risk weights due to financial stability considerations that are currently out for consultation. The draft binding rules do not specify when they should best be adjusted up, and when down, nor how to take into account such potential procyclical effects. Nothing in the proposed binding rules clarifies at which part of the cycle this lever should be used, which is a bit odd for nominally technical rules that have as their key ingredient that a specific lever can be used for financial stability considerations.

The EBA proposals do give a clue as to what information is relevant, but mainly leave the type of response to the supervisor itself. A supervisor eager to apply the law in a conservative manner is left scratching his head as to the optimum course and timing. A supervisor eager or under political or monetary policy pressure to boost a growing economy, or to stop a sliding property market, is free to do whatever it wants even if the longer term effects might be a less safe banking system. For example, the economies of many of the member states currently need a stimulus. Increasing house

prices and office prices based on cheaper lending – if banks do not need to hold so much capital – could help provide such a stimulus. Even though bad lending practices and too low risk premiums and risk buffers for mortgage loans in the USA subprime sector actually kicked off the latest worldwide crisis, the solution to help growth in the short term could be to keep risk weights low, and to keep all options open for national legislators and supervisors. As a result of such pressures it is difficult to blame EBA and its voting members for building in this leeway. However, it does mean that the new binding rules are not very useful if a supervisor or financial stability regulator would like to be able to take measures to ensure the stability of the banking sector and/or the property market. The standards instead excel in less than clear guidance such as 'Take into account housing market developments', which kicks in a wide-open door, and says nothing on whether rising values or buyers interest should lead to an increase in risk weighting (and thus higher capital requirements), or to a decrease in risk weighting (and thus lower capital requirements).

This leaves aside that a discussion could be had on whether a higher risk weight would be best from a technical point of view in the upslope of a boom (to stop irrational exuberance, and build up capital buffers for the eventual decline in property values a few years hence and thus in an anticyclical manner), or on the downslope towards a trough (to increase the potential for bank capital being sufficient to deal with future losses in a value-declining property market, thus limiting the scope for banks to lend to potential new purchasers and forcing them to double down capital for existing and new downward developing mortgage loans, even though for the wider economy this would be procyclical). In this light, an analysis performed by supervisors on the basis of the lengthy data sets available over the boom period and the bust in immovable property markets in almost every member state could have been used to base these standards on an analysis of the costs and benefits of heightening and reducing risk weights in each national or regional property market in the period from e.g. 2000 until now. Indicating when Dutch, Spanish, Irish or any other national supervisor in hindsight would have wished that they used the existing risk weight-adjustment instrument either in a pro- or anticyclical manner during that period might lead to useful indicators as to when it should be used in the future with the best impact on wider financial stability as well as on the resilience provided by larger bank financial buffers.

A compromise solution could be to try to aim for the upper slopes of the boom for an increase, and reduce it when property prices have gone below reasonable long term values. At the bottom of the trough this would stimulate the housing market, especially if the expected losses on the housing portfolio have already been written down in full under a possibly wider definition of default and/or lower valuation of the collateral. Higher risk weights on the remaining fully covered mortgage loans would then no longer be necessary, if – and only if – the risk weight setter is able to correctly call when a boom is under way, or when a property market recession is entering irrationally depressed territory.

It would thus be helpful if the standards clarify whether their primary target is to stabilise the immovable property market in a certain market segment, or to stabilise the banks that lend in that area even if that means restricting loans to a already plummeting property market, or both. That would also help indicate whether there is a need to coordinate across financial sectors and across banks on the standardised and IRB approach (to ensure that banks, insurers, pension funds and other non-bank mortgage loan providers increase or decrease their exposure to the market segment involved in the same manner) which I would favour, or not (to ensure that the banks are safe by

being able – to put it bluntly – to offload the risky and more costly exposure to the overheated property segment, even if that is to unsuspecting insurers or securitisation-investors such as pension funds).

This overall lack of clear indicators and purposes means that I am a bit reluctant to criticise the only clear benchmark that EBA does provide, which has been referenced in the draft standards and made more concrete in the impact assessment. According to it, loss expectations should be a key factor to determine how high the risk weights should be. It is a welcome clarification of intent, and something supervisors might be benchmarked to. However, though I applaud its inclusion, this specific benchmark does clarify two things that in view of pro and anti-cyclical thinking are a bit unwelcome. The first is that higher loss expectations are expected to be the trigger for an increase in risk weighting. As soon as market based loss expectations are made the determining factor, any irrationality in the market suddenly becomes less easy to deal with. This irrationality is part of the accepted market wisdom at that time, so if for ten years prices have gone up, no one 'expects' losses any more. Only once the bust period actually arrives, loss expectations suddenly swing up (sometimes to irrational heights in a panic). Increasing risk weights at that point in time will only strengthen the slide into the abyss. If risk weights instead are already up when loss expectations are still close to nil, then the lever could helpfully be used to lighten the load on the way down, helping to dampen the cycle. That does, however, require supervisors actually to take a stand against 'the sky is the limit' politicians and realtors, which as indicated above may not be their favoured role.

Second, the table appears to indicate that the lowest risk weights are appropriate in 'normal' times. If so, the lever of risk weights is unavailable during the entire trough of the cycle, meaning it has no dampening effect to get the market (and the banks' capital requirements) into a mood that indicates light at the end of the tunnel. From a macroprudential point of view, that seems unhelpful. The lowest risk weights should be only in force at the 'apex' of the bust, so that the lever can be used both in the downswing and the upswing. No doubt this is more the role of the ESRB to point out, but strangely their role as providers of warnings and advisors on the cyclicality of draft-rules is not visibly reflected in the EBA draft standards.

In conclusion, it may be good to re-assess and clarify some of the key concepts, main goals and direction of adjustments in the draft binding rules before they enter into force. Building upon the experience in the past crisis with a 'in hindsight' analysis as to when and how this tool would have been most effective and efficient would be helpful. Both changes would help shelter banking supervisors from being put under pressure to sacrifice long term bank stability against short term political pressure for economic growth.

Also see:

- The separate comment on adjusting the mortgage risk weights
- EU Banking Supervision, chapter 6.2, 6.5, 8, 18.3, 21.2-21.4, and 22.5
- 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