Decision by the Board of the Financial Supervisory Authority to retain the minimum level for the average risk weight on residential mortgage loans of credit institutions that have adopted the IRB Approach

At its meeting on 28 June 2019, the Board of the Financial Supervisory Authority (FIN-FSA) decided

- to retain the minimum level of 15% for the average risk weight on residential mortgage loans[1] of credit institutions that have adopted the Internal Ratings Based Approach (IRB Approach) that the Board decided to introduce on 26 June 2017, with effect from 1 January 2020 for one year pursuant to Article 458 of the Capital Requirements Regulation (CRR). The entry into force of this decision is subject to the EU Council not objecting to the Board's decision. Upon proposal by the Commission, the EU Council may reject a measure under Article 458 proposed by a Member State. The European Systemic Risk Board (ESRB) and the European Banking Authority (EBA) will issue opinions on the matter.

Justifications for the decision

On 29 June 2017, the Board of the FIN-FSA took a decision, upon proposal by the Director General, to set a minimum level of 15% for the average risk weight on residential mortgage loans of credit institutions that have adopted the IRB Approach. According to the decision, the minimum risk weight was to enter into force on 1 January 2018. The minimum level was set pursuant to Article 458 of the CRR.

According to the present analysis, the average risk weights on the residential mortgage loans of credit institutions that have adopted the IRB Approach are very low in Finland, and risk weights vary significantly from one credit institution to another. The risk weights are low both from a risk perspective and compared with the risk weight levels applied in other EU countries.

The risk weights on residential mortgage loans applied by credit institutions do not take sufficient account of the second round effects amplifying the shocks to the economy. Second round effects may stem for example from a reduction in consumption by indebted households in a stress situation. The decline in consumption may, indirectly, increase loan losses and the problems of the corporate sector and, by extension, have more far-reaching consequences for the functioning of the financial system and the economy. The potential second round effects are amplified by high household indebtedness, which has remained practically unchanged since the introduction of minimum risk weights. The indebtedness of households serves to amplify the effects of potential shocks (such as rising unemployment or interest rates) that have a bearing on households' loan repayment capacity. Via the links between

[1] In the application of the provision, a residential mortgage loan is to be defined in accordance with chapter 7a, section 3, subsection 1(2) of the Consumer Protection Act.

the financial sector and the real economy, these effects could develop into systemic effects. In addition, setting minimum risk weights for residential mortgage loans is necessary in order to make sufficient provision for an elevation of house prices in the future to a level which does not reflect the state of the economy, either in general or regionally.

In November 2016, the European Systemic Risk Board (ESRB) issued a warning to Finland regarding the high level of household indebtedness. The ESRB drew attention to the fact that the indebtedness of households may constitute a risk for the stability of the financial system and for the development of the real economy over the medium term.

A decision to retain a national measure as referred to in Article 458 of the CRR must be taken in accordance with the same procedure as the initial decision. In this context, it must be assessed whether measures other than those referred to in Article 458 may be adopted to prevent identified risks. As regards alternative measures other than the systemic risk buffer, the situation has not changed since the initial decision, and based on previous analyses it can be established that they cannot be used to replace minimum risk weights.[2]

Since the decision on minimum risk weights taken in June 2017, a systemic risk buffer has been introduced in Finland. However, there is no justification for replacing minimum risk weights with the systemic risk buffer for the following reasons:

- the systemic risk buffer is primarily designed to ensure that banks' have a sufficient capital base to support long-term, structural risks inherent in the banking sector as a whole, whereas minimum risk weights are designed to ensure that the systemic risks expressly related to residential mortgage loans are sufficiently taken account of in the calculation of capital adequacy;
- the law prescribes detailed conditions for setting a systemic risk buffer, which are based on designated risks that are abundantly present in the credit institution sector, and the indicators measuring these risks, and it would, therefore, be difficult to justify the imposition of a systemic risk buffer on credit institutions that have adopted the IRB approach;
- if the risk weight floor were to be replaced by a systemic risk buffer imposed on the total exposures of credit institutions, this could have an effect on the pricing of risk and on the institutions' incentives to grant credit other than residential mortgage loans;
- achievement of a capital add-on effect equal to that of the minimum risk weight would, in some respects, require a higher requirement than the statutory maximum of 5%.

[2] The suitability of alternative measures (including the introduction of a higher minimum LGD value under Article 164 of the CRR and increasing risk weights using Pillar 2 measures) for strengthening the capital base required to support the residential mortgage loan stock was analysed in connection with the preparation of the decision. The analysis showed that alternative measures would not enable adequate and effective management of observed systemic risks.

The introduction of a minimum level for risk weights for residential mortgage loans has had a minor effect on the capital position of the banking sector. This is explained by the minimum risk weights set for OP Group and Nordea by ECB Banking Supervision for the calculation of capital adequacy. Similarly, effects of the introduction of a minimum risk weight on the lending and other operations of Finnish credit institutions have been negligible.

The FIN-FSA must notify the European Parliament, Council, Commission, European Systemic Risk Board (ESRB) and European Banking Authority (EBA) of its decision to continue application of the minimum level of risk weights, including the changes in risk underlying the decision. The entry into force of this decision is subject to the EU Council not opposing it. Upon proposal by the Commission, the EU Council may reject a measure under Article 458 proposed by a Member State. The European Systemic Risk Board (ESRB) and the European Banking Authority (EBA) will issue opinions on the matter.

The decision to retain the minimum level of risk weight will be in force for one year. In order to ensure the decision covers all the residential mortgage loans granted in Finland, the FIN-FSA will request that macroprudential authorities of other EEA countries apply the measures to branches operating in Finland of credit institutions authorised in said countries and that this be recommended by the European Systemic Risk Board (ESRB) to the authorities concerned.