Mortgage Info 01/06

The New Capital Adequacy Rules – Residential Mortgage Lending

Mortgage Info nos. 6 and 7 examine the impact of the Basel proposals on mortgage lending. *Mortgage Info nos. 6 and 7* focus on residential mortgage lending and on mortgage lending and small and medium sized enterprises respectively.

The Basel Committee on Banking Supervision and the European Commission have both published their second consultation documents on bank capital adequacy. Both documents have May 31, 2001 as their deadline for response.

Credit risk

Two approaches are proposed with respect to the measurement and management of credit risk: the revised standardised approach and the IRBA. The former provides fixed risk-sensitive weighting buckets, whereas the latter, as the name suggests, encourages input from lenders. The IRBA is divided into a foundation methodology and an advanced methodology.

In the foundation methodology, the bank must assess the probability of default for borrowers (PD) assigned to each internal borrower grade. Other risk measures are estimated by the supervisory authorities.

In the advanced methodology, all inputs are on the basis of a bank's own assessment of the risk measures. For retail exposures only the use of the advanced methodology is envisaged. Basel takes the view that the data to measure risk already exists for retail exposures.

Residential mortgage lending

Both documents recognise the importance of residential mortgage lending to the financial sector and to the wider economy, in that:

- it will continue to be weighted at 50% under the revised standardised approach;
- it is included under the internal rating based approach (IRBA) for retail exposures and;
- responsible lending and improved risk measurement and management (using data on LTV ratios, borrowers and valuation) will be rewarded.

Calibration of risk weights for retail exposures

European mortgage lenders are questioning whether or not it is worthwhile to switch to the advanced methodology for residential mortgage lending. Under the IRBA, banking book exposures have been categorised into a number of asset classes including retail and corporate exposures. The Committee has provided tentative risk weights for retail exposures for given PDs (LGD is assumed to be 50%). These are outlined in the table below.

The Committee gives as an example the risk weights for retail exposures based on a calibration that would produce a capital requirement of 4% (50%) for an asset with a 0.7% probability of default (PD), 50% loss given default and a three-year maturity. For corporate exposures, this calibration would give a capital requirement of 8% (100%). Thus retail exposures are considered half as risky as corporate exposures.

Table 1: Calibration of Risk Weight for Retail Exposures in the Internal Rating Based Approach

PD (%)	BRW[1] Retail
0.03	6
0.05	9
0.1	14
0.2	21
0.4	34
0.5	40
0.7	50
1	64
2	104
3	137
5	195
10	310
15	401
20	479
30	605

Source: The New Capital Accord

Maturity

Work was undertaken by the Committee on the calibration of risk weights for corporate exposures. The three-year maturity applied in this work has been transposed into the calibration of retail risk weights. It represents, in part, an attempt by the Committee to take into account residential mortgages, which make up a very significant portion of retail portfolios and which have effective maturities longer than one year. The Committee intends to provide a revised calibration in the final Accord on the basis of a quantitative impact study which is currently underway with industry.

Both Basel and the Commission recognise that there is no agreement on how maturity should be treated. Supervisors consider that the longer a loan, the more risky it is. The experience of mortgage lenders, on the other hand, suggests that a loan is more vulnerable in the first few years and becomes less risky over time. Over time capital is repaid, collateral remains enforceable and increases in value. Typically, mortgage loans are granted from ten to fifteen years or longer. Punitive treatment of longer maturities in the Accord could be a disincentive to long-term lending.

Minimum requirements

Typically, minimum requirements to be met for retail exposures include risk segmentation by product (facility), borrower, delinquency status and vintage. Banks can use additional techniques to segment their retail exposures including, for example:

- different levels of LTV measures for secured loans;
- borrower information;
- loan size and;
- maturity (10 or 30 year mortgages).

Banks must also provide explicit loss estimates and these estimates should be reviewed on a yearly basis. Banks should regard internal data as the primary source of information for estimating loss characteristics.

The Committee supplies a regulatory definition of default which banks must use in estimating losses and collecting default data from their own

[1] BRW – Benchmark Risk Weight

experience. Banks may utilise different definitions of default across different retail products, although all internal definitions must be consistent with the reference definition.

A default is considered to have occurred with regard to a particular obligor when one or more of the following events have taken place, such as:

- the obligor is unlikely to pay its debt obligations in full;
- the obligor is past due more than 90 days on any credit obligation; or
- the obligor has filed for bankruptcy or similar protection from creditors.

There are also requirements with respect to the review of rating systems and processes, data collection and documentation.

Implementation Issues

The transition period for the Accord starts on the date of implementation (i.e. sometime in 2004) and will last for a period of 3 years from that date. The length of the underlying historical observation period used must be at least 5 years and a bank will need to meet this requirement by the conclusion of the transition period. As such, a bank must have a minimum of 2 years of data by the time of implementation; this requirement will increase by one year for each subsequent year of transition.

Next steps

Federation's experts are currently considering:

- the calibration of risk weights;
- the treatment of maturity;
- the minimum requirements and;
- the incentive (if any) to switch from the revised standardised approach to the IRBA.

In particular, the Federation looks forward to the results of the quantitative impact study.

Discussions are currently underway on the Accord at both national and European levels between the mortgage credit sector and their supervisors. The Federation will be responding formally, in due course, to both the Basel Committee and the European Commission.

Contact persons: Mr David Manning or Mr Sacha Polverini
: +32 2 285 40 30
: +32 2 285 40 31
: Emfinfo@hypo.org http: //www.hypo.org