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Asian regulators likely to customise proposed risk weights for mortgages under Basel III

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The Basel Committee's proposed risk weights for residential mortgages may be too light a treatment, and regulators in Asia are likely to customise the numbers to reflect more accurately local market conditions, industry officials said.

Regulators in Asia's leading financial centres, namely Australia, Hong Kong, Japan and Singapore, will soon require banks in their jurisdictions to begin conducting a quantitative impact study (QIS) based on the Basel Committee on Banking Supervision's recommendations to assess the impact of credit risk, operational risk and capital output floor on their capital positions. The QIS is expected to be completed by the first quarter this year, a timeline set by the Basel Committee.

Regulators will use the assessment results from the QIS to plan their implementation approach for Basel III. But Asian regulators are likely to stick to their own standards to ensure banks in their jurisdictions are operating on sufficient capital for the risks they hold, industry officials said.

In jurisdictions such as Australia and Hong Kong where the local property markets tend to be volatile, regulators typically assigned a higher risk weight for residential mortgages. The Hong Kong Monetary Authority (HKMA), for example, assigned a higher risk weight for residential mortgages under Basel II which is 35 percent for banks using the standardised approach, and between 25 and 30 percent for banks using the internal risk-based model approach. The Basel Committee, however, has proposed a risk weight of 20 percent for residential mortgages.

"If Hong Kong were to follow the Basel Committee's recommendations, the risk weight for residential mortgages will come down to 25 percent. I don't believe the HKMA will reduce it. It will leave it at 35 percent for banks using the standardised approach. For banks using the internal risk-based model approach, it will be even more dramatic: many banks will be in the range of 1 to 5 percent [if they follow the Basel Committee's recommendations]," said a consultant who declined to be identified.

Big understatement

The consultant also pointed out that if banks in Hong Kong were to use the figures recommended by the Basel Committee in their calculation for the quantitative impact study, this will likely result in a big understatement.

"It is going to be tricky because major risk will affect the banking business. The Basel Committee has set its expectations that the level of capital is enough [for banks globally] but clearly in Asia it is not," he said.

Kevin Nixon, senior adviser at Deloitte in Sydney and co-lead for its Centre for Regulatory Strategy said, the Basel rules have always been about setting minimum standards.

"The Basel Committee is heavily focused on banks' lending on their balance sheet. These are the things they look at, for example, the risk weight for mortgages. And they have to apply a global minimum standard. They specifically say: 'this is the minimum we suggest you hold as capital.' Many countries around the world generally go above the minimum because they say their [financial] systems are different. They rarely go below Basel's minimum standard," he said.

Nixon also pointed out that it is important to understand that the Basel Committee operates on the basis of consensus, rather than on votes.

"Unless everyone is happy, the Basel standards don't get published. When something is published, it gets signed off by regulators in Japan, China and Singapore, for example. It is not fair to say that the Basel Committee doesn’t take into consideration the situations in Asia because the regulators from China, or Hong Kong or Singapore sit on the committee. These countries are intimately involved in the rule-making," he said.

There are, however, different aspects of the Basel rules which may not apply to some Asian countries simply because certain activities are not carried out in those markets. Nixon cited securitisation as an example of a type of financial instrument which has never been a big part of many Asian's financial markets, and as such the rules on securitisation may not seem relevant to them.

"If countries are not affected by Basel’s proposed rule changes on securitization, they still listen to them and ultimately incorporate them in their local standards even if they come from countries that do not have a large securitization market and even if the rules do not apply to them,” he said.

But for those changes in the Basel rules which feature prominently in some local economies, local regulators will almost invariably agree to the Basel standards, Nixon said.

QIS results will determine whether to embrace or customise

The results from the QIS will determine whether banks will embrace the Basel Committee's recommendations or whether they will customise the numbers to suit local market conditions, said Kishore Ramakrishnan, co-founder at Temple Grange Partners in Hong Kong.

"The QIS done locally is supposed to mirror real market conditions as opposed to simply taking the Basel Committee's prescribed recommendations and applying them to the local markets," he said.

In some countries such as Hong Kong and Singapore, where the local regulators have assigned higher risk weights for residential mortgages, the QIS may show that there is excess capital in their financial system when measured against Basel's minimum standards, in which case the QIS becomes a somewhat academic exercise, Nixon said.

"Even if it was an academic exercise for the banks, it gives theoretical use for the numbers. The real purpose of the QIS analysis is not to see the total numbers but to see the changes in the numbers. When there are changes to the rules, the Basel Committee and individual regulators will want to see what impact the changes to the rules will bring to the U.S., European and Asian markets. It is a useful exercise," he said.

QIS result is important information

The QIS result is important information not only for local regulators, but also for the Basel Committee in its policy-making, Nixon said. While the mortgage markets may differ between countries, the core of the Basel rules, which is about how much capital banks should have in their balance sheet against the loans they make as banks, does not change, he said.

"It is important to understand where the change [in the Basel rules] impact the most because it will be felt differently. It will be important for the Basel Committee to know where the impact of its rules will be felt, how widely it will be felt and to what extent. The Basel Committee has to run the QIS to know the impact, and if you find differences in different parts of the world, that is important information," he said.

Distinguishing between U.S., European and Asian markets

While agreeing the 20 percent risk weight which the Basel Committee has allocated for residential mortgages might be considered low for some jurisdictions in Asia, considerations must be given to the different nature of the financial markets in the United States, Europe and Asia, Ramakrishnan said.

"The 35 percent risk weight which the HKMA has assigned for residential mortgages reflects the retail-heavy nature of Hong Kong's financial market, unlike the U.S. market which is more capital market-driven. I will go one step further to say that the European and Asian financial markets tend to be retail-heavy and they are into corporates lending and so they require slightly different treatment for different asset classes. You will also see primarily retail, corporates and SMEs lending in countries like Germany, France, Ireland and the UK," he said.

Between Asia and Europe, the latter has a bigger capital market notwithstanding the significant amount of retail market activities there. Retail banking and SME lending are the characteristics that make Asia and ASEAN (the Association of Southeast Asian Nations) unique, and so QIS need to be customised to meet local market conditions, Ramakrishnan said.

"Because the Basel Committee can't have a one-size-fits-all recommendation, I am not surprised if Asian regulators [eventually] have to do some tweaks to their local regulations when they implement the capital requirements," he said.

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