Risk-Weighted Assets

What are 'Risk-Weighted Assets'

Risk-weighted assets are used to determine the minimum amount of capital that must be held by banks and other institutions to reduce the risk of insolvency. The capital requirement is based on a risk assessment for each type of bank asset. For example, a loan that is secured by a letter of credit is considered to be riskier and requires more capital than a mortgage loan that is secured with collateral.

BREAKING DOWN 'Risk-Weighted Assets'

The financial crisis of 2007 and 2008 was driven by financial institutions investing in subprime home mortgage loans that had a far higher risk of default than bank managers and regulators believed to be possible. When consumers started to default on their mortgages, many financial institutions lost large amounts of capital, and some became insolvent.

To avoid this problem moving forward, regulators now insist that each bank group its assets together by risk category so that the amount of required capital is matched with the risk level of each asset. The goal is to prevent banks from losing large amounts of capital when a particular asset class declines sharply in value.

How Assets Risk Is Assessed

Regulators consider several tools to assess the risk of a particular asset category. Since a large percentage of bank assets are loans, regulators consider both the source of loan repayment and the underlying value of the collateral. A loan for a commercial building, for example, generates interest and principal payments based on lease income from tenants. If the building is not fully leased, the property may not generate sufficient income to repay the loan. Since the building serves as collateral for the loan, bank regulators also consider the value of the building itself.

A U.S. treasury bond, on the other hand, is secured by the ability of the federal government to generate taxes. These securities carry the higher credit rating, and holding these assets requires the bank to carry far less capital than a commercial loan.

Factoring in Return on Equity

Bank managers are also responsible for using assets to generate a reasonable rate of return. In some cases, assets that carry more risk can generate a higher return to the bank, because those assets generate a higher level of interest income to the lender. Managers have to balance the potential rate of return on an asset category with the amount of capital they must maintain for the asset class. If

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Asset Base

An asset base refers to the the underlying assets giving value to a company, investment or loan. The asset base is not fixed, it will appreciate or depreciate according to market forces. Lenders use physical assets as a guarantee that at least a portion of money lent can be recouped through the sale of the backed asset in the case that the loan itself cannot be repaid.

BREAKING DOWN 'Asset Base'

The value of a home might increase or decrease over time, affecting the underlying collateral in a mortgage. Similarly, the price of a commodity used as the asset base of derivative can also increase or decrease rapidly, changing the price that investors are willing to pay for it. Examples of asset bases include a home (for a mortgage) and factory equipment (business loan). A derivative would "derive" its value from an underlying asset.