STATENS OFFENTLIGA UTREDNINGAR

Memorandum

18 June 2015

Financial Stability Council

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Minutes from the meeting of the Financial Stability Council held on 15 June 2015

Summary

The members of the Stability Council discussed the stability situation and there was consensus that the Swedish financial system is functioning well. The Ministry of Finance, Finansinspektionen and the National Debt Office consider that resilience in the Swedish banking system is satisfactory. All the members of the Council consider, however, that there are a number of risks, of which the high level of household indebtedness and rising housing prices were highlighted in particular. Other risks discussed were the weak European recovery, the situation in Greece, as well as inflated asset prices and low risk premiums as a consequence of the low interest rate situation.

The meeting discussed capital ratios in the Swedish banking system and the advantages and disadvantages of regulations on risk-based capital adequacy rules, leverage ratios and a risk weight floor. Finansinspektionen recommends that capital requirements should continue to be risk sensitive and therefore does not advocate a binding leverage ratio. Finansinspektionen sees no need now to introduce higher capital requirements but wants to wait until there is clarity as to the effects of the Bank Recovery and Resolution Directive and coming international regulation. The Riksbank considers that the capital requirements should be reviewed to strengthen resilience in the Swedish banking system in the longer term. The Riksbank would prefer to see an increase in capital ratios through a combination of different measures. Examples of such measures are higher risk weightings, stricter floor rules or leverage ratios that to varying degrees supplement the risk-based capital requirements. The National Debt Office prefers risk-sensitive capital requirements and if there are problems the risk weightings should be adjusted without changing the approach. Moreover, the benefit of further tightening of capital requirements is probably diminishing and

the effects uncertain. The Ministry of Finance considers that a risk-based approach for capital adequacy is preferable, as it takes account of the banks' risk-taking.

The meeting also discussed household indebtedness. Finansinspektionen, the Riksbank and the National Debt Office have together made an analysis that presents the driving forces behind the sharp rise in household indebtedness since the end of the 1990s. The assessment is that a combination of different circumstances has contributed to the development.

This refers to macroeconomic factors such as falling real interest rates, but also structural factors such as more people owning their own homes, changes in the tax system and a low level of construction.

All members of the Council see risks linked to the high level of indebtedness and therefore see a need to introduce the amortisation requirement to reduce the risks. The Riksbank considers that further measures are needed besides this to manage the risks. The Ministry of Finance is formulating authorisation for Finansinspektionen to introduce an amortisation requirement.

The coming work in the context of the Stability Council will cover a number of different questions ahead of the next meeting of the Council on 16 December 2015. Apart from the questions it is already working on, in the autumn the Council will focus in depth on the following areas:

- Stability aspects of low interest rates.
- The role of the agencies in connection with crisis management – co-ordination and emergency preparedness, including a discussion on liquidity assistance.
- Structural changes in the banking market as a consequence of new regulation, such as the Capital Markets Union.

Present:

Ministry of Finance
Per Bolund, Chair
Ulf Holm
Eva-Lena Norgren
Finansinspektionen
Martin Noréus
Uldis Cerps
Henrik Braconier
Swedish National Debt Office
Hans Lindblad
Lars Hörngren

Mårten Bjellerup
Riksbank
Stefan Ingves
Per Jansson
Martin W Johansson
Financial Stability Council Secretariat
Niclas Alsén

§ 1 Stability assessment

The International Department of the Ministry of Finance gave a brief description of the situation in Greece.

Finansinspektionen and the Riksbank presented their respective pictures of the stability situation for the members of the Council.

Finansinspektionen considers that the Swedish financial system is functioning well and resilience is satisfactory. The banks have good liquidity and capital buffers as well as high profitability and good access to funding. Households on the whole have strong balance sheets and good solvency.

Finansinspektionen highlights three vulnerabilities. In the first place the Swedish banking sector is large and dependent on market funding. This means that problems in the international market can also affect Swedish banks. In the second place the financial system in Sweden is to a great extent interlinked, for example in that banks and insurance companies hold each other's debt (e.g. covered bonds), which implies contagion risks. In the third place household debt is high, which mainly entails macroeconomic risks.

The current situation means that there are several significant risks in the opinion of Finansinspektionen, and international unrest may trigger turbulence in the financial markets. The greatest risks are:

- Low interest rates and compressed risk premiums. Changed market expectations may lead to a rapid rise in risk premiums. That could make asset prices fall, reduce credit supply and slow down growth, which may cause financial turbulence.
- Continued weak growth in Europe combined with low inflation. Further economic slowdown may contribute to even weaker growth and a further fall in inflation. A situation with very low growth and deflation would weaken financial stability in Europe and Sweden. A worsened crisis in Greece could trigger such a shock.

- Rising housing prices and high credit growth combined with highly indebted households.

The Riksbank considers that risk-taking in financial markets is increasing and that there is a risk of inflated balance sheets, overvalued assets or risks not being fully priced. Events that may contribute to increased financial stress include the situation in Greece and mounting geopolitical unrest. But other events can also lead to increased stress. Regardless of what contributes to increased stress the actors in the financial markets may wish to reduce their risk-taking, which may lead to a fall in asset prices and an increase in volatility. In that context the Riksbank also notes that liquidity in a number of financial markets seems to have deteriorated. This may amplify negative effects on the financial system if the appetite for risk should suddenly decline.

The Swedish financial system is currently functioning well. But the risks have increased since the previous meeting of the Stability Council in November 2014. Households' high and increasing indebtedness are today the greatest risk for both macroeconomic development and financial stability. The low interest rates also pave the way for a continued rise in debt and housing prices. Without an amortisation requirement the conditions are worse for dampening debt.

A deterioration in Greece may entail increased volatility and increased risk premiums in financial markets. Sweden only has minor direct economic and financial links to Greece. But if confidence in the monetary union decreases the krona may be strengthened, which can impact Swedish monetary policy.

The National Debt Office does not differ in its basic view of the risks in the financial system and agrees with Finansinspektionen and the Riksbank that household indebtedness constitutes a risk to the economy and may intensify a downturn if the economy is exposed to disruption.

§ 2 Discussion on the need for analyses and further measures

Capital ratios in the Swedish banking system

Finansinspektionen advocates risk-weighted requirements supplemented by a leverage ratio as a back stop.

Finansinspektionen describes four conclusions. The *first* is that if the leverage ratio is set so high that it is binding it may have the long-term consequence of making the banking system in Sweden smaller but riskier. The financial system could become more market oriented and the shadow banking system grow, which has some advantages but the risk that this will reduce financial stability needs analysis. Finansinspektionen estimates that a risk-based capital adequacy requirement is preferable. The *second* conclusion is that in existing studies there is no indication that capital adequacy needs to be higher. The model risks in the risk-based system need to be dealt with, however. Work is currently in progress in the Basel Committee to review and deal with weaknesses in banks' internal methods that in some cases have led to risk weightings that are too low. Finansinspektionen assesses that this will lead to a noticeably higher capital requirement than at present. The *third* conclusion is that the implicit state guarantee remains, which could suggest that capital requirements should be increased further. But implementing the Bank Recovery and Resolution Directive and in the future total loss-absorbing capacity for systemically important banks (TLAC) will lead to a decrease in the state guarantee. Consequently, it is worth waiting and analysing the effects before any further higher capital requirements are introduced. The *fourth* conclusion is that the November Accord[1] 1 of 2011, in which Finansinspektionen, the Ministry of Finance and the Riksbank determined that the capital requirement in the major Swedish banks would be at least 12 per cent, was based on the Basel III accord. However, the Bank Recovery and Resolution Directive is being implemented and TLAC is now under discussion, and in addition the Basel accord is being fundamentally reworked. When these changes have been implemented there may be reason to review whether further changes are needed.

The Riksbank considers that the November Accord 2011 was on the low side and refers to studies indicating that the benefit of capital in the banking system has been underestimated while the costs have been overestimated. The risk weightings have continued to decrease since 2011, largely because the banks apply internal models to a greater extent to determine the risk weightings. The capital requirement from 2011 therefore represents less resilience now than in 2011. The conclusion of this is that capital requirements need to be reviewed to strengthen resilience in the Swedish banking system in the longer term. An increase in capital ratios in the major Swedish banks may take place through combining different measures, such as higher risk weightings, more stringent floor rules or the introduction of a leverage ratio, which to a varying degree will complement the risk-weighted capital requirements. In reply to a question from the Ministry of Finance about how long the work of the Basel Committee will take, the Riksbank's assessment is that it will take a few years before the regulatory frameworks are in place, and

[1] See "New capital requirements for Swedish banks", press release at fi.se, 25 November 2011.

in view of that, the Riksbank thinks there is reason to move ahead of the timetable in some areas.

The Ministry of Finance expressed misgivings concerning a possible risk that national early introduction may mean that the national regulatory framework will again have to be amended when the international regulations are in place. Finansinspektionen shares this assessment.

The Riksbank does not see this circumstance as a hindrance to bringing forward the Swedish regulatory work.

The National Debt Office shares Finansinspektionen's cautious approach concerning non-risk-based capital requirements and supports the current risk-based regulations on capital requirements. It is reasonable that the capital requirements reflect the lending risks while the regulatory framework does not provide the incentives to increase expected yield and risks in the same way as a leverage ratio. There are problems with risk weightings and how they are calculated by the banks. These problems should, however, be dealt with in the context of a risk-sensitive system.

There is a material difference and a difference in principle between making adjustments in the current system and adjustments to the entire model. The National Debt Office also underlines the importance of taking into account the fact that the Bank Recovery and Resolution Directive is being implemented when discussing the capital requirement.

The Riksbank believes that a leverage ratio of 5 per cent is only a small increase from the banks' current average actual leverage ratio, which is about 4.3 per cent. This is equivalent to an increase in capital of about SEK 100 billion, or less than 30 per cent of the major banks' earnings up to 2018. In a long-term perspective the leverage ratio has fallen, and at the same time that is what shows the banks' actual loss absorbing capacity. The purpose of the November Accord was to impose higher capital requirements on the banks, and it is remarkable that that requirement was met through falling risk weightings.

Finansinspektionen does not share the Riksbank's view that resilience would be lower today. On the other hand, they agree with the Riksbank that risk weightings need to be reviewed and that it is a good thing that this is now being done by the Basel Committee. It is important, for example, to ensure that long periods of low losses do not lead over time to downward pressure on risk weightings to levels that are too low. But it would be a problem if the principle of risk sensitivity was entirely abandoned, even if a leverage ratio of 5 per cent would be manageable for the banks in purely financial terms. In general, and from an international perspective the Swedish banks are well-capitalised given the risk in their balance sheets. Given that as the situation is today the banks are not regarded as very high-risk or undercapitalised there is no reason to rush ahead with further measures. The studies that advocate a leverage ratio are static and do not take into consideration dynamic general equilibrium effects when the banks adapt their behaviour and increase risk-taking. Finansinspektionen does not consider it evident that for example the USA's more market-based financial system has been more stable in periods of crisis than the Swedish system.

The National Debt Office prefers a risk-based model. If the model has problems the remedy should be to adjust the risk weightings, not to replace the entire model. The benefit of further tightening of capital requirements is probably diminishing and the effects uncertain. Consequently, there is reason to wait and make a careful impact assessment of tightening the current application and of changing systems.

The European Commission's initiative on a capital markets union is to some extent a reaction to the deterioration of credit supply to small and medium-sized companies, partly as a consequence of the tougher rules in the banking area. At the same time there are signs that the securities markets are functioning less efficiently, partly due to tougher rules in that area. This makes it more difficult to channel credit via securities markets. A transition from a bank-based to a market-based credit system assumes the existence of efficient securities markets.

Finansinspektionen states that they are not against a system in which the market plays a greater role, but such a change should not be made too quickly or without first making a careful evaluation. If a high leverage ratio is introduced the banks can mainly influence their returns by exposing themselves to higher-yield assets, such as through increasing the risk in lending or by securitising low-risk assets. This could lead to a smaller but riskier banking system. The final assessment of the leverage ratio depends on how other components, such as floor rules and total loss-absorbing capacity (TLAC) will be formulated. If these nevertheless entail considerably less risk-sensitive capital requirements, there is less reason to also introduce a high binding leverage ratio.

The Ministry of Finance considers that the banks today are well-capitalised. Careful analysis of the regulatory frameworks and the effects that arise in the issues in question will be needed before any decision can be made, and unwanted effects need to be taken into consideration. A risk-based model for capital adequacy takes the banks' risk-taking into account.

Household indebtedness

The Riksbank describes the analysis made together with Finansinspektionen and the National Debt Office, showing the reasons behind the sharp rise in household indebtedness since the end of the 1990s. The assessment is that a combination of different circumstances has contributed to the development. This refers to macroeconomic effects such as low real interest rates and rising incomes, but also structural factors such as more people owning their own homes, changes in the tax system and a low level of construction. But it cannot be assumed that the economic conditions will be equally good in the long term; they can change, which may affect future developments. This applies for example to interest rates, which are currently at record low levels. The Riksbank, Finansinspektionen and the National Debt Office intend to continue work on household indebtedness, focusing on risks and possible measures.

Finansinspektionen agrees with the Riksbank's description of the driving forces behind household indebtedness. Finansinspektionen's assessment is that many Swedish households are highly indebted and that this constitutes macroeconomic vulnerability, even if the risks to financial stability are small. Even if the debt-servicing ability of mortgage holders today is good, interest rates will rise. The risk that households will not be able to pay their debts is, however, small and resilience to interest rate rises is high. According to Finansinspektionen's mortgage survey 97 per cent of households with new mortgages in 2014 would manage an interest rate rise of 5 percentage points, compared with 92 per cent in 2013. At the same time, households have great assets, a high level of savings and there are few signs of unsound lending. But there are also causes for concern, such as the increase in the proportion of households with mortgages of more than 50 per cent of the value of the property. These households may reduce their consumption considerably if there is a fall in housing prices, thus weakening the economy. The most accurate measure for reducing the number of households with relatively high mortgage loans is to introduce an amortisation requirement. Other alternative measures do not reach this group as accurately and are therefore not as effective in dealing with the risks associated with highly indebted households. In addition, several of these alternative measures would meet the same legal problems as the amortisation requirement has encountered. However, it would be good to have other measures and tools available in the future when the risk picture may change.

Finansinspektionen also stated that there is no data on individual households' assets that correspond to the data on debts. Better access to data would improve the quality of analysis. The Riksbank agreed with Finansinspektionen.

The Swedish National Debt Office shares the view of the Riksbank and Finansinspektionen. At the same time, it is important to bear in mind that households' assets are far in excess of their debts. For the policy issues under discussion here the microperspective of high debt for the individual household is not a primary problem. However, it may be a macro problem. The best way of reducing this risk is to introduce an amortisation requirement.

The Riksbank states that factors other than macrofinancial conditions also affect indebtedness, such as taxes and housing construction. There are several interesting reform proposals in these areas in the recently published annex to the Long-Term Survey of the Swedish Economy "Bostadsmarknaden och den ekonomiska utvecklingen" (the housing market and economic growth); for example, a gradual reduction in tax relief on interest payments, continued reforms of the rent-setting system and improved conditions to increase construction. If reforms in these other policy areas are not implemented there will be greater demand for macroprudential supervision measures. The amortisation requirement is extremely mild in the form proposed, so other additional measures may need to be taken, such as limiting mortgages in relation to income by introducing a debt to income limit , tightening credit assessment through more stringent application of the banks' left-to-live-on estimates (LTLO), restricting households' loans by tightening the mortgage loan-to-value limit, restricting the percentage of mortgage loans at a variable interest rate and increasing capital requirements. It is an open question how all the methods should be combined, and it requires discussion.

Finansinspektionen's powers in the area of macroprudential supervision need to be clarified, according to the Riksbank. It is problematic that Finansinspektionen has a responsibility but unclear powers. Finansinspektionen's powers therefore need to be clarified in law generally and not just with regard to the amortisation requirement. It should therefore also be clearly stated that Finansinspektionen can take measures for counteracting financial imbalances even when there are no immediate risks to financial stability but rather risks of macroeconomic instability.

Finansinspektionen considers that the risks associated with household debt are above all that many individual households are highly indebted. The aggregated debt ratio is not a good measure of risks associated with indebtedness. If the percentage of owner-occupied housing increases, debts at an aggregated level also increase, without the risks necessarily increasing. Finansinspektionen agrees with the Riksbank in the assessment that Finansinspektionen has clear instructions concerning responsibility for financial stability and preventing imbalanced development in the credit market, but that its powers in the latter area are unclear. The legislative support therefore needs to be reviewed, to avoid problems every time a new tool is to be applied. The problem now is that Finansinspektionen has its instructions and is expected to act, but does not have the powers.

The National Debt Office agrees that Finansinspektionen's powers need to be clarified. Moreover, the National Debt Office considers that it is a sign of problems if households have become more active in the bidding process for housing ahead of the introduction of an amortisation requirement. This may indicate that households have a liquidity problem. In general analysing various measures is a good thing, but introduction requires caution because the measures could also have major negative effects. For example, the Riksbank's analysis in its latest Financial Stability Report shows that abolition of tax relief on interest may reduce the GDP level by up to 3 per cent. According to the National Debt Office's assessment this would correspond to about 120 000-130 000 jobs if productivity growth remains unchanged.

The Riksbank is doubtful about using simplified and uncertain estimates to draw such conclusions. Moreover, the Riksbank considers that there is no exact limit for when indebtedness at aggregate level is a problem; for example, is 180 per cent critical or not. The aggregated level is one thing, but the uncertainty that exists at individual level is not good and better statistics at household level are needed.

Finansinspektionen reports that households have gradually become better at amortisation in recent years. The amortisation requirement is partly a matter of locking in that behaviour, so that it does not deteriorate in the long term. The increase in the countercyclical capital buffer that Finansinspektionen recently proposed is linked to households' increasing indebtedness. The buffer is to be raised, partly because increased credit growth means a somewhat increased risk of losses in the banking system.

The Ministry of Finance believes that household indebtedness is a worrying factor. There is great public acceptance for, and insight about, the need to have a sound amortisation culture. The Ministry of Finance is formulating authorisation for the amortisation requirement for Finansinspektionen and discussions are currently in progress with opposition parties. It is important that there is broad political consensus on the amortisation issue. The Government may revisit the issue in the future if further measures are needed. It is important to introduce one measure at a time and analyse the effects before moving on with more measures. The Government is also asking for more up to date reference data on how the amortisation culture has developed, not least in the past year when there has been discussion about amortisation requirements.

An analysis is also being made of Finansinspektionen's powers in addition to the amortisation requirement. The Government will report back on this matter.

§ 3 Future work

Future work in the context of the Stability Council will include the overall issues listed below. The next meeting will be on 16 December 2015. Apart from the questions the Council is already working on, in the autumn it will intensify its work in the following areas:

- Stability aspects of low interest rates.
- The role of the agencies in connection with crisis management – co-ordination and emergency preparedness, including a discussion on liquidity assistance.
- Structural changes in the banking market as a consequence of new regulation, such as the Capital Markets Union.