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Memorandum

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Minutes from the meeting of the Financial Stability Council held on 23 May 2014

Summary

The members of the Council welcomed the proposal from Finansinspektionen on Swedish banks' capital levels, but have different opinions concerning the activation and size of the countercyclical capital buffer. The Swedish National Debt Office is doubtful about the timing in view of the weak state of the economy. The Riksbank would like to see a larger buffer than that proposed by Finansinspektionen to strengthen banks' resilience against the imbalances accumulated in household indebtedness. The Council is agreed on carefully following developments and making an overall analysis of the situation of households. Moreover the Council instructed the working group to analyse issues concerning the need to bring forward the introduction of requirements concerning banks' leverage ratio in Sweden, requirements concerning debt instruments that can be converted to equity in the event of a crisis, liquidity requirements and concrete alternatives aimed at strengthening households' amortisation behaviour. On the basis of these analyses the Council will discuss the need for further measures.

Present:

Ministry of Finance
Peter Norman, chair
Johanna Lybeck Lilja
Pål Bergström
Finansinspektionen (Financial Supervisory Authority)
Martin Andersson
Martin Noréus
Henrik Braconier
Swedish National Debt Office
Hans Lindblad
Lars Hörngren

Mårten Bjellerup
The Riksbank (Swedish central bank)
Stefan Ingves
Kerstin af Jochnick
Kasper Roszbach

§1 Stability assessment

Finansinspektionen considered that international economic recovery is continuing, but is fragile. Financial conditions have improved and risk premiums have fallen. Recovery in the Swedish economy is expected to continue, but there are indications of somewhat weaker developments than predicted in forecasts published in recent months.

External risks in terms of a weaker economic situation constitute the single greatest risk to financial stability in Europe and Sweden. This development could be triggered by economic problems in important emerging markets. In a situation of low and falling inflation the risk of deflation increases, which would increase the real debt burden.

In combination with an upward rebound of risk premiums from the very low current levels, particularly in some parts of the euro area, the consequences for stability could be serious. The main domestic risks are high housing prices, household indebtedness and the banks' dependency on market funding.

The Riksbank gave a more detailed description of the economic situation and the brighter real economic outlook. Private consumption is growing faster than incomes, which means that savings are decreasing. Growth in Sweden is estimated to be between 2.5 and 3.2 per cent in coming years and the upturn in demand is relatively broad. In the euro area the Riksbank is expecting growth of about 2 per cent in 2015 and 2016, while growth in the USA is expected to be about 3 per cent.

Development in the financial market is stable. However, the Riksbank sees a risk in the recent very low risk premiums and market volatility. Given the existing risks the risk premiums and volatility would normally be higher. The banks are profitable and have good access to funding. Large enterprises also have good access to funding and encounter low lending rates. The banks are signalling that lower demand is behind the low corporate credit growth.

The greatest risks to financial stability are deemed to be increased risk-taking among market participants due to long-term low interest rates, low risk premiums and being ill-prepared for exiting some positions. In addition there are risks of worsened developments in Europe and of an escalation of the crisis in Ukraine. In Sweden rising indebtedness in the household sector is a considerable risk. The Riksbank shows that debt as a proportion of disposable income will reach 180 per cent in 2016.

§ 2 Discussion on the need for further measures

The need for more capital

Finansinspektionen summarised the coming measures that it presented on 8 May:

- The 2011 November Accord will now be implemented. The four major banks will thereby have a common equity Tier 1 capital requirement of at least 12 per cent. The systemic risk buffer is set at 3 per cent, together with a Pillar 2 requirement of 2 per cent.

- The Pillar 2 requirement is being tightened in that a larger percentage must be covered by common equity Tier 1 capital. The transparency of Pillar 2 requirements will also increase through regular publication.

- The risk weight floor for mortgages will be raised from 15 to 25 per cent.

- The countercyclical buffer will be activated. Finansinspektionen assesses that the value should be 1 per cent of the risk-weighted assets. All in all, this means that the average common equity Tier 1 capital requirement for the major banks will be 16.4 per cent.

The purpose of the countercyclical buffer is for banks to build up a buffer at times of high credit growth that can then be reduced when credit growth abates. If the standard method recommended by the Basel Committee and the ESRB is applied, the indicative threshold of the buffer will be 1.5 percentage points. The standard method is based, however, on a statistical estimate with several uncertain assumptions and the indicative threshold should only be seen as a reference value. In deciding a buffer value it is necessary to make a weighted and qualitative assessment of several other factors.

Finansinspektionen notes in its assessment that on the one hand household debt is growing from an already high level. On the other hand credit growth does not currently appear to be particularly high – but rather as relatively normal for the household sector and almost low for the corporate sector. The risks of household indebtedness as a result of structural factors being high already at the outset should instead be handled via the risk weighting floor for mortgages. In light of this Finansinspektionen's overall assessment is that the value of the countercyclical capital buffer should be 1 per cent.

The Swedish National Debt Office supported the capital requirements for Swedish banks, but underlined the importance of analysing long-term target levels. The low resource utilisation, low inflation rate and shrinking credit gap mean that the time for activating the countercyclical capital buffer could be questioned. At the same time the effect of activating the countercyclical buffer is assessed as relatively marginal. The Swedish National Debt Office pointed out that funding costs for banks may fall with higher capital requirements since credit givers run less risk. It is also important to evaluate and analyse the effects of higher capital requirements on both GDP growth and on public finances. The Swedish National Debt Office further underlined the need to start making a cohesive assessment of the effects of regulation, including effects of coming EU rules. Partial analyses indicate effects on GDP growth in the order of one or a few tenths of a percentage point for each percentage point increase in capital requirements. This could mean that the implemented and announced changes amount to a weakening of general government finances of tens of billions of SEK. At the same time the Swedish National Debt Office emphasised that they are not as uneasy about household indebtedness and finances as several others are. The level of debt is high, but the risk must also be assessed on the basis of total assets and the fact that a large part of the increased debt can be explained by households now owning their housing to a greater extent. The Swedish National Debt Office also pointed out a study by the National Institute of Economic Research showing relatively moderate effects of a fall in housing prices and expressed uncertainty as to whether household indebtedness is really a stability problem.

The Riksbank was of the opinion that Finansinspektionen's announced measures are a step in the right direction, but that capital requirements remain low in relation to the size of the Swedish banking sector. The Riksbank noted that the common equity Tier 1 capital ratio has gradually increased, while the leverage ratio has stayed between 3 and 4 per cent in recent years. The Riksbank therefore considered it important to investigate as soon as possible any other ways that exist to increase capital levels in the Swedish banking system, and pointed out the need to analyse whether a leverage requirement should be introduced earlier for Swedish banks as a complement to the risk-weighted capital requirements. Household debt has long been increasing and at times the pace of growth has been considerable. This has built up imbalances that should be seen in the light of the vulnerabilities in the Swedish financial system. It is a good thing that the countercyclical buffer is activated to strengthen the banks' resilience, but the Riksbank considers that it should be set at 2.5 per cent. An increase from 1 per cent to 2.5 per cent means approximately SEK 22 billion in increased capital requirements, which would approximately correspond to the banks' profits for one quarter.

Finansinspektionen shared the Riksbank's assessment that capital requirements need to account for the risks of household indebtedness and stated that it is just because of this that the mortgage risk weighting floor is being raised to 25 per cent. Besides, cyclical changes can be parried with the counter-cyclical buffer. Risk weightings have increased fivefold in a short period; from about 5 to 25 per cent. This is a powerful measure to strengthen resilience and address the risks for banks of the structurally high indebtedness among households.

As regards the banks' capital ratios in general, Finansinspektionen noted that the international regulatory agenda is moving towards less risk-sensitive capital requirements, partly through standardisation of risk weightings, partly through preparation of a leverage ratio.

The Ministry of Finance emphasised that analyses of effects on the economy can be improved. The effects on macroeconomic development are also important; the rules and their application are not just a matter of financial stability. The economic situation is uncertain and downside risks predominate. At the same time it is calm on the financial markets with low stress levels. It is often at such times that imbalances build up. Consequently the Ministry of Finance welcomes the measures announced by Finansinspektionen.

The Bank Recovery and Resolution Directive will make it possible to have debt instruments that can be converted to equity or written down in the event of a crisis. This will require opinions on how much such convertible capital the regulations should require etc. Consequently the Ministry of Finance considered that these questions should continue to be analysed. The question of the leverage ratio should also be analysed further. The European Commission has the opportunity to submit proposals about such requirements in 2016. National requirements may be implemented before the EU introduces leverage ratios. The need to bring forward the introduction of binding national requirements to complement risk-weighted capital adequacy requirements should therefore be analysed.

The Financial Stability Council also discussed whether higher capital requirements can lead to increased securitisation and whether this is a problem. There was agreement that increased capital requirements can increase incentives to securitisation. In countries with fewer risk-sensitive capital requirements, such as the USA, there is also a large securitisation market. The financial system is then subject to other risks; for example the banks may have large exposures and implicit commitments towards securitised portfolios. In the long term the structure may also change in Sweden. Securitisation may entail poorer credit quality in the portfolios due to changed incentives in credit assessment. There are both advantages and disadvantages to such a system that need to be analysed further.

The banks' funding

The Riksbank stated that they had been following developments in banks' liquidity risks for a long time. Mortgages with very long or perpetual maturity are funded with bonds with an average maturity on issue of about 4 years; in other words the maturities are only matched to a small extent.

This implies structural liquidity risk. In addition, major banks' exposure to structural liquidity risk is higher than that of comparable European banks.

As regards liquidity coverage ratio (LCR) requirements it is good that Sweden has gone ahead with implementation, but the banks' krona reserves are low or at times even very low. At their lowest the liquidity reserves amount only to 5-10 per cent of the liquidity in kronor that the banks are estimated to need during a stressed scenario lasting one month. The banks' resilience to liquidity shocks should be strengthened so that the banks themselves can manage short-term liquidity disruptions in Swedish kronor. The Riksbank therefore advocates the introduction of a special LCR in kronor with a floor of 60 per cent for example. This would prevent the banks from returning to the at times extremely low LCR levels that have sometimes been the case. The Riksbank emphasised that they should be lender of last resort, not lender of first resort.

Another question is the foreign currency reserve and its funding. The Riksbank sees problems with the Swedish banking system, which is so dependent on market funding in foreign currency. The Riksbank considers that the banks should be responsible for the foreign currency reserve funding costs. There is a need to deal with the question and reduce the problem, regardless of whether it is done in the form of tax, contribution or reserve requirement.

The Swedish National Debt Office considers that the question of the funding of the foreign currency reserve should be handled together with the question of the size of, and decision-making procedure for, the foreign currency reserve. The latter is being drafted at the Government Offices on the basis of an inquiry proposal. Proposals on how these issues should be dealt with should be referred to the Riksdag for an overall decision. As regards LCR in kronor there is a danger that a requirement of this kind would bind government securities to the banks. That risks worsening liquidity in the government instrument market, which would make effective management of central government debt more difficult. In a crisis situation dollar assets are also more liquid than kronor assets and therefore give banks better contingency liquidity facilities. Only if they were unable to exchange foreign currency to kronor would the banks have a direct need of krona liquidity. In such an extreme situation the Riksbank should be able to grant loans in kronor with dollar assets as collateral. Consequently there is no reason to replace dollar assets with krona assets in the banks' LCR buffers. LCR in kronor may also require central government borrowing in excess of requirements. Admittedly, the possibility of borrowing in excess of requirements was proposed in the Hessius inquiry, but then for other reasons. It would be odd if central government borrowed in excess of requirements and managed assets because banks are required to hold greater liquidity reserves in kronor. The British and Australian central banks manage the liquidity question in domestic currency by allowing the banks to buy liquidity insurance from the central bank.

Finansinspektionen would also prefer reserves in more liquid dollar and euro assets. Low Swedish kronor reserves are not a problem if there are large dollar and euro reserves which can also be used to cover outflows of Swedish kronor. The Riksbank would thus not need to become "the lender of first resort". If larger liquidity reserves are needed, the LCR should be raised in general, but not for kronor assets. A reserve of this kind would be counter-productive, regardless of how it affects the government bond market. In a situation where Swedish banks find it difficult to raise funding in the market, dollar and euro assets would probably be regarded as the least risky and thereby the most liquid. It is therefore difficult to see that dollar or euro assets could not be accepted as collateral by the National Debt Office or the Riksbank. A further drawback with an LCR in kronor is the risk that our neighbouring countries implement the corresponding requirements in Norwegian and Danish kronor. Ultimately this could lead to Swedish banks' liquidity reserves consisting of a higher proportion of relatively small currencies which are illiquid in crisis situations, at the expense of more liquid global reserve currencies.

However, the Riksbank pointed out that an analysis of the government bond market and the banks' holdings of these bonds show that the current levels would not affect the government bond market to any significant extent. The Riksbank was also of the opinion that it is the wrong premise that the government bond market must never be affected under any circumstances. The Riksbank is concerned about banks' low liquidity reserves in Swedish kronor.

The Ministry of Finance stated that the Swedish banks are highly dependent on market funding, which to a large extent is in foreign currency. This funding has also led to an expansion in the currency reserve. The government is of the opinion that the financial sector must contribute to covering these costs which otherwise are paid by tax-payers. It intends to report back with proposals for how this should be done. The Ministry of Finance was of the opinion that the financial stability council should continue to analyse the need to regulate liquidity.

Household indebtedness

Finansinspektionen started the discussion with a brief presentation. Debt is at a high level in both a historical and international perspective. However, last year the analysis group of the Council for Co-operation on Macroprudential Policy reported that some 90 per cent of the increase in debt could be explained by various structural factors mainly increased ownership of housing due to conversion from rented to tenant-owner apartments.

The mortgage investigation also shows that new housing loan borrowers have relatively good capacity to manage financial stress. The above-mentioned study carried out by the NIER on behalf of Finansinspektionen analysed the macro-economic effects of a fall in house prices. Calculations indicate that a 20-per cent fall in house prices would lead to consumption falling by around two percentage points.

Finansinspektionen has taken a number of measures to counteract rising household debt and to reduce their vulnerability. The mortgage cap was introduced in 2010 and in 2013 the risk weight floor on 15 per cent was implemented. At that time, the Swedish Bankers' Association also recommended a requirement that mortgages be repaid down to 75 per cent. These two measures have been tightened up during the current year by increasing the risk weight floor to 25 per cent, while the Bankers' Association has increased its repayment recommendation to 70 per cent. Individual repayment plans are also being introduced.

Any further measures should primarily focus on the functioning of the housing market, and secondly on household demands for mortgage loans, for example by influencing repayment behaviour. In this perspective, other policy areas, such as fiscal and housing policy, may also lead to increased stability and counteract increased household debt.

The Riksbank pointed out that the mortgage loan investigation provides valuable information. However the Riksbank was of the opinion that new credit data show that debt is more widespread than was previously realised and that many people are not reducing their debt, but also that better data is required regarding households' assets. The Riksbank has studied Finansinspektionen's data for banks' estimates of households' surplus income after housing costs have been paid and their conclusion is that there are major differences between the banks. The interest rates used in their estimates vary between 5.9 and 8 per cent but there are also major differences in other parameters, such as repayment periods. This means that the assessment of a borrower's financial potential differs, and the Riksbank expressed concern that if the standards used are too low then in the event of a disruption a mortgage could be a greater burden on the household than indicated by a calculation of surplus income after housing costs.

The measures taken are good but more is needed. Initially Finansinspektionen should promote the introduction of sound minimum levels for the standard values used by banks in their calculations of surplus income after housing costs, since some banks set them at a very low level. This could help offset the risk of major consumption adjustments. The amortisation culture needs improvement and that does not just apply to new mortgages. The Riksbank pointed out that the preparatory group should examine this more closely and propose the formulation of amortisation requirements ahead of the Council's meeting in November.

The Swedish National Debt Office stated that whether household debt is a problem or not must be determined on the basis of an overall analysis of households' finances. This includes also taking households' assets and repayment capacity into account. In addition households should be allowed to have different preferences concerning their consumption and how they allocate their funds. This should not be too tightly controlled by central government. Amortisation or savings should at least be equivalent to the wear and tear on the housing property. For a normal household and a normal detached house this could be two to three thousand Swedish kronor per month. The Swedish National Debt Office also underlined that debt ratios fall over time as a consequence of real incomes and inflation.

Finansinspektionen considered that the Riksbank's new credit data for mortgages confirms the earlier picture and does not give reason to change the assessment of risks of indebtedness. Finansinspektionen agreed in some part with the argument about calculations of surplus income after housing costs, but thought at the same time that there is no mechanical link between these calculations and the banks' credit decisions and consequently this is not a particularly effective policy instrument from the point of view of regulation. Finansinspektionen does not consider that lending is imprudent even though some banks have somewhat lower requirements in their calculations of surplus income after housing costs. To obtain any great effect a regulation of calculations of surplus income after housing costs would probably need to be detailed and affect the entire credit assessment. This type of regulation would risk taking over one of the banks' main tasks and could lead to standard setting where all banks routinely use assumptions prescribed by the authorities. Regulation on a more fundamental level in the form of general advice supplemented by more supervision could, however, be an opportunity, but other measures are preferable if the aim is to influence household indebtedness. Finansinspektionen is willing to discuss and analyse different measures.

The Ministry of Finance summed up by stating that the agencies had different views of household indebtedness, but that there was agreement that the Council should carefully follow developments and make an overall analysis of the situation of households.

On the basis of this, the Council will discuss the need for further measures.
The preparatory group and the Council will revisit the three areas dealt with at the meeting; the banks' capital, the banks' funding and liquidity and household indebtedness (see annex 1).10

§3 Future work

The two first areas are affected by decisions within the EU or the G20/FSB. However, all three areas include possible national initiatives.