STATENS OFFENTLIGA UTREDNINGAR

Memorandum

20 November 2014

Financial Stability Council
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Minutes from the meeting of the Financial Stability Council held on 11 November 2014

Summary

The members of the Council discussed the stability situation in the Swedish financial sector and noted that even if resilience is deemed to be good, there was general unease – albeit in different degrees – about the high and rising indebtedness in the household sector. In light of this, Finansinspektionen's analysis and proposals on how households' amortisation behaviour could be strengthened were welcomed. The proposal means that households should annually amortise the equivalent of 2 per cent per year of a mortgage until the loan-to-value ratio is 70 per cent, and thereafter one per cent until the loan-to-value ratio is 50 per cent. The requirement will apply to new mortgages.

The Riksbank considered that Finansinspektionen's proposal is a step in the right direction, but that it is not enough to manage the problems of household indebtedness. The Riksbank therefore emphasised the need for continued measures to manage high household indebtedness. The other participants emphasised instead that it is important that the measures now being considered do not threaten the fragile economic recovery and thus financial stability and that it is necessary to take one step at a time and carefully evaluate the effects of measures already taken. From somewhat varying premises the Council's members agreed to instruct the preparatory group and the secretariat to follow the development of debt and to hold continued discussions in the Council on the overall effects of measures taken.

The meeting also discussed the need for Sweden to take action ahead of the EU in the regulatory process and introduce a leverage ratio for the banks. Finansinspektionen shared its analysis and stated that there are

risks and considerable consequences in the long term to allowing a non-risk-weighted requirement to govern the banks' capitalisation. Even though it would give a simpler and superficially more transparent capital requirement, it would create strong incentives for the banks to increase their risk-taking in a non-desirable way.

Against this backdrop Finansinspektionen considers that Sweden should delay introduction until the regulation has been adopted at EU level. The Swedish National Debt Office agreed with Finansinspektionen's analysis and conclusions. The Riksbank stated that Swedish banks' leverage ratio, despite high risk-weighted capital adequacy requirements, is low in a European and a historical perspective. The Riksbank therefore considers that a leverage ratio should be introduced and be higher than the minimum requirement of 3 per cent now being discussed in the EU. A level of 5 per cent to be introduced gradually between 2016 and 2018 is reasonable according to the Riksbank.

After a general mention of a number of current international regulatory initiatives the Council discussed areas for the preparatory group and the secretariat to continue work on ahead of the next meeting of the Council in June 2015. Against the background of the various assessments made concerning the need for further measures there were also somewhat different views on the focus of coming work. The Council agreed on the following points:

- The drivers behind household indebtedness and the risks linked to them need continued analysis. The analysis of the effects of measures already taken and announced should also continue. In particular an in-depth analysis of distribution policy and regional consequences of Finansinspektionen's amortisation requirement should be made. In addition, the development of relevant indicators should continue to be monitored and where necessary further measures analysed.

- Continued analysis of capital ratios and funding in the banking system with special focus on international regulation initiatives on total loss absorbing capital, leverage ratios and net stable funding ratios should be implemented.

Present: *Ministry of Finance*
Per Bolund, Chair
Ulf Holm
Pål Bergström
Finansinspektionen
Martin Andersson
Martin Noréus
Henrik Braconier
Swedish National Debt Office
Hans Lindblad
Lars Hörngren
Mårten Bjellerup
Riksbank
Stefan Ingves
Kerstin af Jochnick
Kasper Roszbach
Financial Stability Council Secretariat
Niclas Alsén

§ 1 Stability assessment

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

Finansinspektionen considers that global recovery continues to be uneven. International forecasters estimate that growth will be about 1 per cent in the euro area in 2015, but Finansinspektionen sees considerable risks on the downside. There are risks of a triple dip in Europe as a consequence of a weak real economy, geopolitical risks and rising real interest rates. As far as Sweden is concerned growth is dependent on recovery in the rest of the world, but there are also other risks. Low inflation contributes to increasing the real debt burden and together with the restricted scope for monetary policy this increases the risk of deflation, which would impact Swedish growth negatively.

For the domestic financial market there are risks in the form of increasing housing prices and household indebtedness. There are several fundamental contributory factors to the housing price development, including a low supply of housing, demographics, urbanisation, income increases, low interest rates and ineffective use of the housing stock. All in all lending to households is now increasing by just under 6 per cent annually and the rate can be expected to rise if the economic recovery takes off. However, households have good resilience and the banks have strong liquidity, high capital adequacy and can manage their funding; i.e. both households and banks are stress resistant. The risks that exist are the banks' dependence on market funding and the increase in household debt.

The Riksbank described the increased volatility in the financial markets. Since then volatility has returned to lower levels. Risks to financial stability exist in the form of poorer growth prospects and geopolitical unease. Stress tests of European banks were well received and Swedish banks can continue to raise funding at low cost. In Sweden housing prices and household debt continue to increase at a fast pace from levels that are already high. Households' mortgages are increasing at an annual rate of about 6 per cent, which is almost twice as fast as GDP. The fact that the debt ratio has stabilised in recent years is

partly a consequence of lower interest rates and thereby higher disposable incomes. The historically low interest rate situation suggests that mortgages will continue to rise and the Riksbank's forecast is therefore that indebtedness will continue to increase in coming years. At household level debts have continued to rise. The level of the debt ratio, not just the rate of increase, is significant for consumption, as indicated by the experiences of Denmark and the Netherlands.

Swedish banks have good common equity Tier 1 capital ratios, but little capital in relation to total assets compared with many other European banks. In a historical perspective Swedish banks' equity capital in relation to total assets, the leverage ratio, has decreased while their assets have increased considerably more than GDP and this needs to be addressed.

The Swedish National Debt Office expressed concern that macroeconomic development in Sweden is weaker than expected due to the international situation. Otherwise the Swedish National Debt Office agreed in all essentials with Finansinspektionen's stability analysis.

§ 2 Discussion on the need for further measures

In-depth discussion on household indebtedness

Finansinspektionen presented its analysis of indebtedness in the household sector, and then gave an outline of the measures intended for presentation at a press conference later in the day.

Finansinspektionen considers that Swedish households have large debts, but also large assets. The debt ratio has stabilised since 2010 when the mortgage loan-to-value ceiling was introduced. Structural factors explain the main part of the rise up to 2010, such as a higher percentage of home owners, lower taxation on housing, lower interest rates and that households become established in the labour market later in life. However, part of the increases remains to be explained. International studies show that there are greater reasons for unease over the rate of increase in debts than over the level as such. In 2011 households' amortisation behaviour started to improve and Finansinspektionen's quick survey, carried out in September and October 2014, shows that 80 per cent of new mortgage holders amortise their loans. The increase in amortisation is about 50 per cent compared with 2013, both due to more people amortising and to larger average amortisation payments. Of those with a loan-to-value ratio of more than 70 per cent the picture is that almost all of them amortise, as do many of the households with a loan-to-value ratio of more than 50 per cent.

Finansinspektionen assesses that the credit risks linked to mortgage lending are small. At the same time there are macro risks associated with high indebtedness relating to highly mortgaged households.

Finansinspektionen's assessment, based on international experience, is that consumption among households with loan-to-value ratios in excess of 50 per cent may react fast and intensely to macroeconomic shocks. This behaviour could intensify cyclical fluctuations.

Consequently, one premise for Finansinspektionen's amortisation proposal is that amortisation requirements should not include mortgages where the loan-to-value ratio is below 50 per cent. At the same time it is natural for households with a higher loan-to-value ratio to amortise more. Therefore a reasonable balance is that households should amortise the equivalent of 2 per cent, annually, of the mortgage until its loan-to-value ratio is 70 per cent, and thereafter 1 per cent annually until its loan-to-value ratio is 50 per cent. That means that the proposal will mostly affect households that in future have a loan-to-value ratio of between 50 and 70 per cent, i.e. households that at present do not amortise so much. To enable households to adapt and to limit the negative effects on demand in the economy the requirements will only apply to new mortgages. Apart from the augmented amortisation requirements, Finansinspektionen's proposal means that the improvements in amortisation culture that have taken place since 2011 will be secured by the proposal.

There is a need for flexibility in amortisation requirements, since they would otherwise risk reducing stability. Flexibility may be in the form of allowing households a period of grace in connection with unemployment, sickness etc. Given this flexibility, the assessment is that the stability effect of the proposal will be positive.

The macroeconomic consequences of the proposal are expected to be a considerable decrease in households' loan-to-value ratios in the long term. The phase-in will take time and is expected to achieve full effect within a 20-year period.

It is expected that demand for housing, and thus housing prices, could be reduced by about 5 per cent according to Finansinspektionen's calculations, but there is considerable uncertainty. Lower housing prices contribute to lower indebtedness and thereby can promote stability. The households not yet in the market are expected to benefit from lower prices.

The direct effect on household consumption is expected to be small, but could be greater if housing prices are affected. In the short term the total effect on consumption is estimated to be a decrease of 0.5 per cent, and in the long term the effect will probably be negligible.

Finansinspektionen sees that continual follow-up of measures taken is valuable, and that the Council can assist in this analysis. Several measures have been taken, including the mortgage loan-to-value ceiling, increased risk weightings, amortisation recommendations, individual amortisation plans and today's proposals by Finansinspektionen. The effects of these measures need to be followed up before more is done.

The Riksbank had shared its analysis with other participants in the Stability Council before the meeting. In the opinion of the Riksbank the consequences of the Swedish Competition Authority's assessment of the Swedish Bankers' Association's amortisation proposal must be investigated. Finansinspektionen replied that the issue of the Swedish Bankers' Association's amortisation proposal is not so easy to investigate since the European Commission may also have views about such an agreement. The industry agreement alternative is thus to be regarded as impracticable.

The Riksbank asked how Finansinspektionen's proposal will be formalised. The information from Finansinspektionen was that a regulatory project will be set up, i.e. a proposed regulation will be drawn up and then circulated for comment. Only new mortgages will be covered. What needs to be investigated is how new mortgages are to be defined, but a guideline for this already exists in the mortgage loan-to-value ceiling and its definition of new mortgages. Finansinspektionen emphasised that flexibility must be formulated well. The situations – such as unemployment or illness – that may warrant exemption from the regulation will be made clear in the referral memorandum. Finansinspektionen is hesitant to restrict flexibility quantitatively; the premise is rather that this should be followed up qualitatively in supervision.

The Riksbank asked about what consideration Finansinspektionen had given to the possibility of relating the mortgage to the size of household income instead. Finansinspektionen stated that there are both advantages and disadvantages to relating the requirement to income but the main reason for relating it to loan-to-value is that it is simpler and clearer and thus easier to understand for both banks and mortgage holders.

The Riksbank considers it natural that if a mortgage is taken out it should be paid back. At the beginning of the 21st Century amortisation culture disappeared and it needs to return. Swedish households have too much debt compared with the rest of the world and the Riksbank sees a risk that if debts and incomes grow at the same rate as in the past ten years the aggregated debt ratio will rise to about 230 per cent in ten years. High debt and rising housing prices may entail serious consequences for both real economic growth and financial stability. Higher debts make households more vulnerable to various disruptions that may lead to weak growth in consumption and employment. It could be particularly problematic if housing prices also fall, as in Denmark, for example.

The Riksbank considers that Finansinspektionen's proposal is a step in the right direction, but that it is not enough to manage the problems of household indebtedness. Even if Finansinspektionen's proposal is not sufficient to solve the problems of household indebtedness it is important and valuable that measures are taken immediately. Thereafter it is important to frequently evaluate the effects on household indebtedness in the form of targeted monitoring for a good many years to come. Since the effect of Finansinspektionen's proposal on household indebtedness is expected to be small, it must be supplemented by several measures that can dampen demand for credit. Conceivable measures that should be analysed further are tightening the mortgage loan-to-value ceiling, restricting the percentage of credit at a variable interest rate and an increase in the minimum level of the banks' left-to-live-on estimates. Therefore the Riksbank considers that the Financial Stability Council should instruct the preparatory group to continue to analyse the need for further measures and submit concrete proposals to the meeting of the Council in June 2015.

The Riksbank believes that we will be confronted with questions concerning other policy areas, such as imbalance in the housing market and taxation questions. An analysis of what would constitute an appropriate percentage of a mortgage with a variable interest rate would be valuable. This is in view of the banks' dependence on external funding and the effects of Swedish variable mortgage rates if the cost of this funding rises. This analysis could also be made in the context of the Stability Council.

Finansinspektionen does not consider that at present there is any need for further measures in addition to the planned amortisation requirement. Further measures from Finansinspektionen can only be considered if earlier and planned measures prove to be insufficient. It is of great importance to proceed with caution so as not to alter conditions for households and the housing market too fast or too much. However, Finansinspektionen is positive towards analysing tax relief on interest and possible effects on indebtedness of increased building.

The Swedish National Debt Office agreed by and large with Finansinspektionen's views. The debts are a risk and it is reasonable if everyone saves amounts that at least correspond to wear and tear on the housing property. For excessively indebted households it is reasonable for saving to be in the form of amortisation, but for loan-to-value ratios under 50 per cent it is preferable if households themselves decide on the form of savings.

The amortisation culture that is starting to emerge is positive and Finansinspektionen's proposal to ensure that it is safeguarded is well-balanced even though some caution should be observed. Consequently an in-depth analysis of the distribution policy and regional policy effects is necessary. The proposal may entail a risk of segregation and increased stability risks in the short term. It may even lead to lock-in effects, which reduce mobility in the housing market. The proposal may also increase sensitivity to disruptions and thus the risks in the short term. It is important not to forget the risk of policy errors, particularly in times of weak growth in the rest of the world.

In addition, consideration must be given to how increase in debt resulting from increased building is to be dealt with. Total mortgage debt will then increase in the economy, but is not a reason to tighten lending. An overall analysis would need to be made of how households and banks will be affected by both this and earlier measures implemented. This analysis should take into account not only the financial stability perspective but also how households' entire investment perspective is affected, how alternative measures such as changes in taxation affect the economy and how a larger percentage of fixed-rate mortgages would affect stability. When analysing the effects of changed taxation rules the effects of differences between drawing in liquidity via amortisation, i.e. own saving, and taxes that draw in income to central government should be taken into account.

In combination, however, Finansinspektionen's proposal strengthens and consolidates the change in amortisation culture, which the Swedish National Debt Office welcomed.

The Ministry of Finance shared the other agencies' unease concerning the level and rate of increase in household debt and therefore welcomed Finansinspektionen's analysis and proposal. However, the Ministry of Finance emphasised the importance of not going too fast but instead carefully analysing and evaluating the consequences of earlier and now proposed measures, so that the total effects in themselves do not threaten financial stability. This should be a high priority task for the Council, the preparatory group and the secretariat.

The Ministry of Finance also highlighted the importance of carefully analysing the effects of an amortisation requirement on different groups in society, for example new house buyers. In that context emphasis was also given to the importance of analysing the interaction between an increased amortisation requirement and the existing mortgage loan-to-value ceiling. The Ministry of Finance also raised the question of analysing the total effect of various measures on first-time-buyers. Moreover, the Ministry of Finance asked whether the effect of housing demand could be expected to increase in metropolitan areas compared with the country as a whole. Finansinspektionen has not as yet had the opportunity to analyse this in detail, but considers it likely that the effect of the proposal will be greater in metropolitan areas.

The Ministry of Finance also wondered how banks and households can be expected to act before the new requirement comes into force. Finansinspektionen does not expect that prices and growth in lending will increase temporarily up to the time the proposal has been implemented. The assessment concerning the banks is that they will probably adapt quickly to future requirements. Nor are the banks expected to withdraw the amortisation plans they currently apply for new borrowers.

The banks' capital – leverage ratio

Finansinspektionen presented its analysis concerning whether Sweden should introduce a leverage ratio before it is required by the EU, i.e. before

2018. At present the banks have risk-weighted capital requirements, which mainly function well. It is reasonable that greater risks lead to higher capital requirements and also create strong incentives for the banks to measure and manage their risks, which fundamentally is very positive. Risk-weighted capital requirements have, however, been criticised on several points; they are difficult to understand; the banks are able to estimate certain parameters themselves on the basis of their own loss history and in some cases it may be difficult for supervisory authorities to assess the reasonableness of these estimates; and retrospective models have a tendency to underestimate future risks. In light of this, international regulatory work in recent years has moved in the direction of restricting the impact of the models on capital requirements. An extreme way of doing this is to introduce a measurement that is not risk-weighted, such as a leverage ratio. This is a measurement that is easy to understand and does not contain any errors of measurement. A leverage ratio can also manage the risk that the banks will push down the capital requirement through internal models.

Finansinspektionen considers, however, that there are risks and considerable consequences in the long term if risk-weighted capital requirements are abandoned. The leverage ratio measurement is based on all assets having the same risk and if it is a binding requirement it creates a strong incentive for the banks to increase their risk-taking. The focus will move towards measuring return and not risk. In that way the market phenomenon in which actors "chase" higher returns without considering the risk will to a greater extent also characterise the banks. This phenomenon is relatively well documented and is clear in countries that use non-risk-weighted capital requirements, such as the USA, where banks' assets have considerably higher returns and thus also higher risk, partly because assets with lower risk, such as mortgages, are securitised. A possible consequence will be that risk capital in the economy is used less effectively.

Finansinspektionen therefore considers that a leverage ratio should be a safety valve but not the binding capital requirement. Consequently, there is no reason for Sweden to introduce it earlier since the level in Swedish banks is already sufficiently high (more than 3 per cent). A higher leverage ratio requirement would mean that it is no longer to be regarded as a safety valve, but instead as a binding requirement. This would entail a major change in relation to today's risk-weighted capital requirements that Finansinspektionen does not consider to be desirable. On the other hand, Finansinspektionen is positive towards continued discussion concerning the level of the risk-weighted capital requirements in the longer term.

The Riksbank agreed that focus should be directed at the banks' capital ratio and the Council should discuss the matter. The Swedish bank sector is large and if the banks become distressed it could be very costly to society. Financial crises entail major macroeconomic costs and can also give rise to considerable problems in public finances. The banks' significance for the Swedish economy has increased over time, yet equity capital in the banks has decreased. Consequently, to increase resilience in the Swedish banks it is reasonable to introduce a leverage ratio as a complement to the risk-based capital adequacy requirements and to introduce it in advance. Just as the risk-based capital adequacy requirements, the Swedish requirement should be set higher than the minimum requirement indicated in the Basel III agreement. A leverage ratio should be introduced gradually over a longer period of time to give the banks time to meet the requirement. A ratio of 4 per cent from January 2016 and 5 per cent from January 2018 is reasonable. If the major banks distribute half of their expected profits they are estimated to have a leverage ratio around or more than 5 per cent as of 1 January 2018.

The Swedish National Debt Office shared Finansinspektionen's assessment and underlined that the matter of whether risk-weighted or non-risk-weighted capital requirements are binding may be of decisive significance for the banks' handling of mortgages, for example. Changes in the direction of non-risk-weighted requirements must therefore be preceded by careful analysis.

Current regulatory issues

The Riksbank started by reporting on current issues being discussed in various fora. The Financial Stability Board will publish a document on total loss-absorbing capital (TLAC) shortly, ahead of a report on the subject to the G20 summit. For large banks TLAC will specify how much debt can be converted to equity in case of resolution. In addition there are questions as to where these debt instruments should be placed in cross-border banks. There is reason to continue this work in the Financial Stability Council. Another current issue concerns liquidity coverage ratio requirements in Swedish kronor.

Finansinspektionen and the Swedish National Debt Office did not agree that liquidity coverage ratios in kronor is a current issue. Such a requirement has already been investigated and discussed by the Financial Stability Council. Finansinspektionen and the Swedish National Debt Office decided at that time that such a requirement was not warranted for stability reasons because it would weaken Swedish banks' liquidity buffers.

Finansinspektionen agreed that TLAC is an important matter and mentioned that the European Banking Authority will also be sending out a consultation paper on the criteria for determining the level of the requirement. The Basel Committee is discussing standardised risk weightings and a proposal will be coming shortly. After reaching consensus on a Net Stable Funding Ratio (NSFR) the next step will be EU implementation.

§ 3 Future work

Given the different assessments made concerning the need for further measures there were also somewhat differing views on the focus of future work in the preparatory group and the secretariat ahead of the next meeting of the Council in June 2015. The Council agreed on the following points:

- The drivers behind household indebtedness and the risks linked to them need continued analysis. The analysis of the effects of measures already taken and announced should also continue. In particular an in-depth analysis of the distribution policy and regional consequences of Finansinspektionen's amortisation requirement should be made. In addition development of relevant indicators should continue to be monitored and where necessary further measures should be analysed.

- Continued analyses of capital ratios and funding in the banking system with special focus on international regulatory initiatives on total loss-absorbing capital, leverage ratios and net stable funding ratio requirements should be made.