



Minutes from the meeting of the Financial Stability Council held on 12 June 2017

Summary

The Stability Council¹ discussed the stability situation. At present the financial markets are functioning well. At the same time, there are several vulnerabilities and risks that make the Swedish financial system sensitive to shocks. Housing prices and household indebtedness are the main risk to the Swedish economy in this area. Households' resilience against future shocks therefore needs to improve.

The fact that the Swedish banking system is large, interconnected and dependent on market funding creates vulnerabilities in the financial system. The banks are dependent on there being a high confidence level in both the Swedish banking system and the Swedish mortgage market. Considerable resilience is required in terms of both capital and liquidity.

The Council discussed the negotiations on the EU banking package and possible consequences for Sweden in light of harmonisation of regulations, where Sweden wants to be able to apply high national requirements.

Finansinspektionen presented information on the proposed stricter amortisation requirement. The Riksbank and the National Debt Office welcome the initiative and will later submit comments in their consultation

¹ Present: *Ministry of Finance*: Per Bolund, Chair, Ulf Holm, Aino Bunge; *Finansinspektionen*: Erik Thedéen, Martin Noréus, Henrik Braconier; *National Debt Office*: Hans Lindblad, Johanna Fager Wettergren, Mårten Bjellerup; *Riksbank*: Stefan Ingves, Kerstin af Jochnick, Olof Sandstedt; and *Financial Stability Council Secretariat*: Niclas Alsén.

responses. The Government will take a position on the final proposal after the consultation procedure.

The authorities discussed liquidity in the government bond market, the size of the foreign currency reserve, Brexit negotiations and international work on resilience of the financial system.

Ahead of the next meeting of the Stability Council on 5 December 2017, the Council members will continue to discuss several of the matters discussed at the meeting, including household indebtedness and the resilience of the banks. The Committee will continue to work together on scenario exercises.

§ 1 Stability assessment

The authorities presented their stability assessments.

The recovery of the world economy continues and recent development in international financial markets has been stable. The Swedish economy is in a situation with a combination of sound economic growth and low interest rates. At the same time, the authorities see several vulnerabilities and risks in the Swedish financial system and for the Swedish economy.

Structural factors, combined with the state of the economy, have given rise to imbalances between supply and demand in the housing market. Housing prices and household indebtedness are creating financial imbalances and pose the greatest risk to the Swedish economy in this area. The authorities noted that prices of commercial property are rising and that bank lending has increased in this sector, which needs to be monitored going forward. In addition to their bank loans, many households are also indirectly in debt via tenant-owner associations' loans.

The authorities also noted that the global low interest rate environment creates further risks. Actors may take greater risks in their pursuit of higher yields and assets risk overvaluation. If interest rates rise to higher levels, asset prices may come under pressure. Permanently low interest rates could instead entail problems for life insurance companies.

The fact that the Swedish banking system is large, interconnected and dependent on market funding creates vulnerabilities in the financial system. Banking is a cross-border sector with major commitments in foreign

currency. Additionally, in Sweden almost all housing financing is via the banking system. The banks are therefore dependent on there being a high confidence level in both the Swedish banking system and the Swedish mortgage market. Consequently, considerable resilience is required in the banking system, where high capital and liquidity requirements are central components.

The Chair noted that the view of the situation is largely shared, but that evaluation of risks in the housing market as well as the resilience of Swedish banks varies somewhat. The Council will continue to discuss these matters during the meeting.

§ 2 Discussion of analyses and any measures

Resilience of the financial system

The Chair described the EU banking package negotiations, which concern changes in capital and liquidity requirements and minimum requirements for eligible liabilities (MREL). The negotiations are characterised by a desire to harmonise the rules to a greater extent within the banking union. For Sweden it is important to set requirements that allow for the risks that exist in the country, including macroprudential and systemic risks.

It is also important to see how capital requirements and minimum requirements for eligible liabilities affect each other. The Government therefore instructed Finansinspektionen and the National Debt Office to report on how these requirements interact. In addition, the Chair noted that the framework for recovery and resolution also includes the resolution reserve, where the Government has drawn up a proposal for an adjusted resolution fee.

Finansinspektionen assesses that resilience in the financial system is satisfactory, and that the present Swedish liquidity and capital requirements have benefited financial stability. Having high buffer requirements, and not just minimum requirements, means that the banks can bear large losses in a future crisis. Today's risk-based capital requirements create incentives for banks not to take excessive risks. International regulation, with high minimum leverage ratio and floor requirements, risk reducing the buffer margin and changing the incentives, which would reduce financial stability.

In the work on the banking package it is also important to ensure that sufficient macroprudential supervision measures are available.

The Riksbank assesses that there are considerable vulnerabilities in the banking system and that resilience needs to be strengthened. This applies to both the banks' ability to manage liquidity risks and their capital ratios. The banking package contains watered-down proposals compared with what was discussed by the Basel Committee. It would be unfortunate if there is a maximum harmonisation level, such as a 3 per cent leverage ratio. The Riksbank previously recommended 5 per cent for the major Swedish banks, but it may also be appropriate to have an even higher level in future. The Riksbank also considers that supervisory authorities should make formal and public decisions on Pillar 2 requirements.

The National Debt Office highlights that Sweden has had a framework for bank recovery and resolution, a resolution framework, in place for more than a year. This means that now it is the banks' owners and lenders that must bear the costs of a distressed bank, not the taxpayers, which in itself provides an incentive for reduced risk-taking by banks. This in turn means that the probability of a crisis decreases as a consequence of applying the resolution regulations. We now have current European examples, where the new tools have been used to manage a distressed bank effectively.

The authorities also discussed ongoing negotiations on clearing of derivatives. Since the United Kingdom is a dominant actor in the clearing market the question is linked to Brexit. The Commission is expected to make further proposals linked to how clearing in countries outside the EU is to be managed.

Stricter amortisation requirement

Finansinspektionen presented the proposal for a stricter amortisation requirement, meaning that new mortgage holders taking out large mortgages in relation to their income will need to amortise more than at present. The reason that the stricter requirement is needed is that housing prices are high, household debt is growing rapidly and the proportion of households with high debt ratios is increasing. Highly indebted households are more sensitive to shocks and may reduce their consumption in a crisis. The stricter amortisation requirement is expected to lead to households buying cheaper housing, borrowing less and paying off their debts faster. That will rapidly

reduce their vulnerability. Finansinspektionen will send out a consultation memorandum this summer and make a board decision this autumn. Finansinspektionen expects the Government to then make a clear decision as soon as possible based on the proposals submitted. This is important for an effective decision-making process for macroprudential supervision.

The National Debt Office thinks that this is a good proposal that strengthens households' incentives better than a debt to income limit. At the same time there is no lack of regulation. The problem is rather that it is very cheap to borrow and that there are structural imbalances in the housing market. The National Debt Office also pointed out that a very rapid construction rate may also create risks, which has been observed historically and in other countries.

The Riksbank considers that a stricter amortisation requirement is a reasonable initiative, but it is still necessary to direct broader measures towards household indebtedness and the housing market. The Riksbank will provide a more detailed view in its consultation response. The Riksbank pointed out the policy dilemma that follows from real interest rates being to a great extent determined globally, at the same time as there is imbalance in the Swedish housing market. Apart from what has been discussed, it would also be advisable to encourage households to fix interest rates on their mortgages to a greater extent.

The Chair noted that the Government regards the housing market from a broad perspective. It is positive that construction has increased, but it is important to draw attention to the effects it has on indebtedness. To be able to meet future needs for measures, the Government is continuing the work of drawing up a broad mandate for Finansinspektionen for macroprudential supervision. The Government welcomes Finansinspektionen's initiative concerning a stricter amortisation requirement, and will take a position when it receives the final proposal.

Analysis of the government bond market

The authorities are in agreement that liquidity in the government bond market is working satisfactorily at present.

The National Debt Office mentioned that liquidity has, however, deteriorated since 2008, which is partly an effect of new regulation. In

addition, central banks' purchases of government bonds and low interest rates have contributed to reducing liquidity. At the same time, the stable interest rate level has meant that the market has nevertheless functioned satisfactorily. The risk is that a more volatile market would impair its function. In future there is a risk that rising liquidity premiums will lead to rising borrowing costs for the State.

Finansinspektionen also pointed out that it is difficult to assess on the basis of liquidity in a normal situation how the market will function in a crisis. The Riksbank's purchase of government securities and the banks' unwillingness to maintain trading books makes the market support role of the National Debt Office more important than usual.

The Riksbank has bought government securities since 2015 and now holds about 40 per cent of the stock. The purchases have had an impact on the general interest rate situation in Sweden and the Riksbank estimates that they have contributed to the favourable economic development and the fact that inflation has moved closer to the target. The assessment of the Riksbank is that the purchases have not affected the functioning of the market to any great extent.

The authorities were agreed on continued analysis of the question.

Size of the foreign currency reserve

The Riksbank underlined that Swedish banks need to insure themselves against liquidity risks in foreign currency. But it is also important to have an adequate foreign currency reserve readily available in an emergency. It is the responsibility of a country to have a foreign currency reserve that is deemed reasonable by the rest of the world. The Riksbank must be able to independently take responsibility and manage its own balance sheet, which is also in line with the Maastricht Treaty. The Riksbank has considerable international support from the IMF and ECB and others with regard to its financial independence and the size of the foreign currency reserves. The Riksbank is able to fund the foreign currency reserve in its own name but believes that it is more cost-effective to borrow via the National Debt Office.

The Chair agrees that it is the task of the banks to maintain adequate liquidity. In addition, the Riksbank has an emergency preparedness role.

There is currently no clear regulation of how funding for the foreign currency reserve should take place. The proposal the Government will present aims at creating clarity around this. The Riksdag has stated that an arrangement in which the Riksbank has unconditional drawing rights for the national debt is not reasonable.

The National Debt Office has not made its own assessment of an appropriate foreign currency reserve size, but has long pointed out that the current unconditional drawing right arrangement needs to be reviewed. The National Debt Office therefore welcomes the Government's clarification of the arrangement and proposes a regulatory code for borrowing to strengthen the foreign currency reserve and that this should be done via the National Debt Office. It is important to regulate that arrangement in law. In this context it would be unfortunate, and against the intentions of the Riksdag, for the Riksbank to decide to circumvent the proposed changes and fill the foreign currency reserve by borrowing in its own name.

Finansinspektionen supports the Government proposal to reduce the foreign currency reserve. The combination of a foreign currency reserve to manage acute problems and the National Debt Office's ability to borrow more if necessary to top up or further strengthen the reserve is well-considered. The National Debt Office has been able to borrow in previous crises, and should be able to do so in the future as well. In addition, since the financial crisis the regulation of the banks' liquidity buffers has come into existence and a resolution framework introduced. This reduces the need for a large foreign currency reserve. Finansinspektionen shares the assessment by the National Debt Office that it would be unfortunate if the Riksbank circumvented the intentions of the Riksdag.

§ 3 Other international questions

The Chair pointed out that the election in the United Kingdom has led to more uncertainty as to how the Brexit negotiations between the EU and the UK will be. The negotiations are to start in June. Cooperation between the Swedish authorities on the matter functions well and the Swedish National Audit Office's evaluation of the Swedish authorities' emergency preparedness in connection with the Brexit referendum gave the authorities a good rating.

Finansinspektionen presented information on the ongoing work in the EU supervisory authorities, including with regard to the effects of Brexit on cross-border companies.

§ 4 Scenario exercises

The Stability Council Secretariat presented information on a scenario exercise that took place on 4 May. The purpose of the exercise was to practice Swedish authorities' crisis management of financial companies.

The Chair underlined that this is valuable work that is to continue and that it is important that lessons from the scenario exercises are utilised.

§ 5 Future work

Ahead of the next meeting of the Stability Council on 5 December 2017, the Council members will continue to discuss several of the matters on the agenda of today's meeting, including household indebtedness and the resilience of the banks. The Committee will work together on scenario exercises and a manual for recovery and resolution and utilise lessons from scenario exercises already held. Moreover, the preparatory group will be instructed to discuss the work of cross-border reciprocity and management of the agreements that exist. Several countries have applied the new framework for recovery and resolution and the preparatory group will be instructed to analyse experiences.