



Financial Stability Council

**Minutes from the meeting of the Financial Stability Council held on 16
December 2015**

Summary

The members of the Stability Council discussed the stability situation. Their assessment is that the financial system is functioning well at present, but at the same time there are risks and structural vulnerabilities. The members highlighted in particular the unease concerning risks associated with household debt. The level of debt is high and rapidly increasing, which, in combination with high asset prices and rising housing prices, increases the risk of future price falls. In that scenario, highly indebted households may reduce their consumption considerably. One possible trigger could be rapidly rising interest rates.

There is broad consensus that measures to counteract household indebtedness are necessary. The Council's members welcome the planned implementation of an amortisation requirement, but have varying views on the need for further measures against the risks associated with household indebtedness. Finansinspektionen, the Riksbank and the National Debt Office consider that it is important that Finansinspektionen will have a clear legal frame of reference to fulfil its remit concerning macroprudential supervision. The Government is now preparing the matter and it is important to secure broad political consensus on a coming proposal.

The meeting also discussed stability risks resulting from low interest rates. The effects of low interest rates include an increase in indebtedness and a rise in asset prices, at the same time as valuations of housing and equities are high, with a heightened risk of a price fall. The situation with very low interest rates also implies increasing challenges for life insurance companies.

The Council also discussed the different roles of the agencies in the new framework for bank recovery and resolution that will be introduced through the Resolution Act on 1 February 2016. The National Debt Office and Finansinspektionen are preparing to apply the new framework and described that work. In addition, the role of the Riksbank was discussed with regard to liquidity assistance, both in connection with an institution taking measures under its recovery plan and when an institution is resolved and being administered by the resolution authority. The practical role of the Stability Council in bank recovery and resolution was also discussed.

Ahead of the next meeting of the Stability Council on 7 June 2016 the Council's members will discuss a number of different questions. Apart from the questions the Council is already working on, in the spring it will intensify its work in the following areas:

- The role of the authorities in crises
- Structural changes as a consequence of new regulation, as well as capital ratios in the Swedish banking system

The National Debt Office sees the need for even broader macro and equilibrium analysis, for example in the form of scenario exercises. The Chair agreed with this.

Present:

Ministry of Finance
 Per Bolund, Chair
 Ulf Holm
 Eva-Lena Norgren
Finansinspektionen
 Erik Thedéen
 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

The situation in the financial markets, assessment of macroeconomic and financial stability risks

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

Finansinspektionen emphasised that the global recovery is continuing but the picture is fragmented. There is gradual recovery in Europe, while the Swedish economy is developing well. The weak European recovery constitutes the greatest real economic risk to Swedish financial stability, where low growth, low inflation and low profitability in European banks pose a threat. Market interest rates are exceptionally low, but seem to be on the way up. There has also been a slight upturn in Swedish interest rates that may be linked to expectations of increasing borrowing requirements for dealing with the flow of refugees. Risk premiums for various assets continue to be depressed. However, low risk premiums also constitute a risk to financial stability, as a rapid upturn may impair the function of markets where Swedish banks obtain funding. However, the risk has decreased somewhat since the meeting in June as the risk premiums have risen.

Finansinspektionen highlighted three structural vulnerabilities in the Swedish financial system. In the first place, Swedish banks are dependent on market funding. In the second place this funding is relatively short-term and funds lending in the longer term. In combination this makes Swedish banks sensitive to disruptions in their funding markets. It is for these reasons that Finansinspektionen requires that Swedish banks be well-capitalised and have large liquidity buffers, and stress tests show that the banks' resilience is good. In the third place households' debts are now rapidly rising and many households are highly indebted. In combination with rising housing prices, the risk of future price falls is increasing. The risks associated with household indebtedness have risen since June and Finansinspektionen estimates that the risk will be heightened for a number of years to come. From this perspective it is positive that an amortisation requirement can now be put in place.

The Riksbank considers that the financial system is functioning well at present. Yet at the same time there are structural vulnerabilities that make the financial system sensitive to economic shocks. The Riksbank's analysis shows that valuations on several asset markets are at historically high levels and that risk premiums are low. This means a heightened risk of price falls. If stress makes an appearance in the financial markets it may lead to reduced risk-taking, which may bring about increased risk

premiums. This may mean a rise in the banks' funding costs, which may ultimately lead to reduced household consumption when interest rates rise. All in all, this would have a negative impact on the economy.

Housing prices have been increasing substantially for many years. This applies particularly to tenant-owned housing, which has seen a much greater increase than disposable incomes. This situation mainly poses a risk to the economy, but in an unfavourable scenario it may also entail risks to financial stability. In the first instance the risk is linked to the Swedish banks' market funding of their mortgage lending. In the second instance, poorer economic development may lead to credit losses on corporate lending.

Market confidence in the Swedish economy is important for the banks' funding costs, since weakened confidence may lead to an increase in funding costs.

The level of the banks' capital implies that resilience to shocks is still too low. Resilience needs to improve, and this applies in particular to liquidity stress in Swedish kronor. Capital ratios in the Swedish banking system therefore need to increase.

The National Debt Office agreed in several ways with Finansinspektionen and the Riksbank on the matters presented. The National Debt Office is not anxious about financial stability or that household indebtedness could result in credit losses. However, there are risks of falls in private consumption. The risks need elucidation in a broader macro perspective than has so far been the case.

The Swedish economy is currently characterised by stronger growth than expected and the extensive inflow of refugees is fuelling demand further. At the same time, the labour market is coloured by rising employment, but also by structural difficulties that are manifested in significant and growing matching problems and political proposals that, according to the National Institute of Economic Research, if anything will, raise the level of long-term unemployment. In addition, price expectations of firms and households have started to grow, as has underlying inflation.

The Swedish economy is also currently coloured by rapidly rising housing prices and household debt. The combination of accelerating income growth, strong employment, rising resource utilisation and a highly expansionary policy is historically very unusual and continues to contribute to imbalances.

There is a risk that both resource utilisation and strength of demand are being underestimated and that a reverse in the interest rate situation could therefore come earlier and more abruptly than expected by households. This could bring a drastic rise in borrowing costs that in turn could trigger a more palpable downturn in property prices and subsequent adjustments to household saving and consumption.

The National Debt Office stated that it is somewhat surprising that the tensions created by the current combination of trends, including various parts of economic policy, are not being discussed more. It is important to have broad debate on this to ensure and be reassured that reasonable choices are being made.

The Riksbank noted, in response to the National Debt Office's proposal concerning broader analysis, that the Riksbank has previously pointed out the risks of household indebtedness and what it may mean for the Swedish economy. There are cyclical effects and structural effects, that are weighed against each other, which will always make it difficult to justify and take measures right now. There is never a perfect time for introducing measures, which itself is a problem.

Finansinspektionen sees risks in an expectations-driven upturn in housing prices. It may mean that a change, when it occurs, may be very significant. Consequently, it is important that Finansinspektionen is able to use further macroprudential supervision tools. Apart from the amortisation requirement, Finansinspektionen is currently investigating the need for and consequences of further measures, such as a "debt to income limit". As regards capital requirements on the banks, Finansinspektionen shares the Riksbank's view that Swedish banks have a low capitalisation level. It is not relevant to compare the leverage ratio in Swedish banks with international investment banks or banks with high exposure to emerging markets, as the latter are higher risk operations. Finansinspektionen underlined that the Riksbank's and Finansinspektionen's stress tests show good resilience in Swedish banks. As regards liquidity coverage ratios in Swedish kronor, this has already been discussed by the Stability Council. Finansinspektionen's assessment is that it is most important for the banks to have good liquidity reserves in central foreign currencies, which they do.

The Riksbank underlined that the banks' liquidity in Swedish kronor, according to available data, is very poor in some institutions. That situation needs to be dealt with.

The National Debt Office agreed as regards the risk that the situation and circumstances of any measures are never perceived to be "right". But

the historically very unusual situation that just now prevails, with a combination of a highly expansionary economic policy and such things as increases in the employment rate and accelerating income growth, increases the risk of growing imbalances and tensions. Both cyclical and structural factors are currently pulling in the same direction. The National Debt Office also pointed out that they did not share the Riksbank's concern about the banks' liquidity reserves and that special requirements on reserves in kronor are not warranted. In a scenario in which dollar and euro assets cannot be converted to kronor the financial system would have other and greater problems.

The Ministry of Finance concluded the discussion under this item and noted that there is reason to make a broader analysis before the next meeting of the Stability Council.

The Riksbank's proposal for amended collateral

The Riksbank explained that the proposal for amended terms and conditions for collateral in RIX is intended to reduce the Riksbank's credit risk. The changed terms and conditions mean to some extent a return to the terms and conditions in force before the financial crisis. The proposal means reduced credit risk and increased risk diversification when lending to banks.

Finansinspektionen referred to a consultation response written together with the National Debt Office.¹ Finansinspektionen thinks it is positive that the matter is now being brought up in the Stability Council as the proposal is clearly linked to financial stability, liquidity and indebtedness.

§ 2 Discussion on the need for analyses and further measures

Household debt

The Riksbank described work in progress together with Finansinspektionen and the National Debt Office. At the previous Stability Council meeting the agencies presented an analysis of the driving forces behind indebtedness. Now the risks have been analysed. There are two risks associated with high indebtedness:

¹ In a joint consultation response, Finansinspektionen and the National Debt Office oppose the Riksbank's proposed amended provisions for collateral for credit in the Riksbank; "Proposed amended provisions for collateral for credit in the Riksbank" (Ref No 2015-00700).

- Households encountering payment problems (credit risks)
- Deterioration in macroeconomic development (macro risks)

Households have good margins against economic shocks and they also have a strong payment responsibility for their mortgages. Credit losses in the banks may arise, but this is a secondary risk. There is a greater risk that the macroeconomic effects will be significant, due to lower private consumption. Households' expectations are that the interest rate level will be low for a long period. There is a risk that households will focus on reducing debt if there is a price fall, for the purpose of restoring their balance sheets. The proportion of households with a debt to income ratio in excess of 300 per cent increased from 36 to 40 per cent between 2014 and 2015.

As regards the households' asset side, there are no statistics after 2007 to enable assessment of how household wealth and savings have developed, and the lack of these statistics is a problem. Swedish households have large assets, but if problems arise, assets such as equity may fall in value. There is a risk that market confidence in Swedish banks may deteriorate in some cases.

The Ministry of Finance presented information on the ongoing legislative work of authorising Finansinspektionen to implement an amortisation requirement. It is proposed that the legislation will come into force on 1 May 2016. It is important that there is long-term stability in this type of matter. The general discussion that is being conducted in Sweden, on various requirements and any need for further measures, is estimated to have a psychological effect on the behaviour of households. It is important that measures do not result in too great a reaction from households.

The National Debt Office considers that various stress tests are a good thing, but that it is also important to assess additional macroeconomic effects. Many banks require that households are able to cope with a considerably higher interest rate level than today's, for example 7–8 per cent, in order to obtain a mortgage. What would be the effect if interest rates actually rise to such a level? A large percentage of households would manage to meet their commitments, but the effects on consumption and the real economy may be substantial, due to a considerable drop in disposable income.

The Ministry of Finance shares the concern of the National Debt Office and refers to research showing that households react by reducing consumption, not by selling other assets.

The Riksbank considers that it is of the greatest importance that both the Government and responsible agencies take measures with a view to offsetting the risks of household indebtedness. It is also of the greatest importance to clarify which macroprudential supervision tools can be used by Finansinspektionen. The coming amortisation requirement is not sufficient. There are also concerns on the supply side of the housing market. There is no single measure that can solve the problem; it requires a combination of different measures and the Riksbank has previously presented various proposals. Unless Finansinspektionen's mandate for macroprudential supervision is made clear, there is a risk that they will be forced to take measures with reference to financial stability. Regardless of what happens, measures must be taken in time, and it is not reasonable to discuss it for another 18 months since there is a great risk of difficulties arising during that period.

The issue of household indebtedness is extremely important for the Swedish economy and for Swedish authorities, and all responsible authorities are exhorted to find a solution to it.

Finansinspektionen agrees that if there is a substantial rise in interest rates housing prices would fall and that would have negative effects on the Swedish economy. As shown by the three authorities' analysis, however, direct credit risks linked to household indebtedness are deemed to be limited. Hence the risk of significant losses on covered bonds is limited. At the same time liquidity problems can arise, and liquidity supply in a crisis thus becomes important. Overall, however, it is assessed that the greatest risks will arise for the macro economy. In that context it is problematic that Finansinspektionen's powers to take measures are unclear, as it is not legally established that measures to handle macro-economic stability risks can be taken. Consequently, there is a need for legislative authorisation establishing which tools Finansinspektionen may use in relation to household indebtedness. Finansinspektionen therefore encourages the Government and opposition to give Finansinspektionen the tools needed to prevent the Swedish economy from getting into a serious situation.

The Riksbank holds the same view as Finansinspektionen concerning the need for legislative authorisation. Measures that affect households' cash flows, such as changed tax relief on interest and real estate tax, can be seen as part of fiscal policy. If too few of such measures are implemented, other types of measure directed at the financial markets are required.

The National Debt Office shared the view that it is important to clarify the powers of authority. The National Debt Office pointed out further that it is important to differentiate between measures that make it more expensive through changing the relative price of borrowing, such as amortisation requirements, tax relief on interest, interest rate levels and capital requirements and measures to restrict households' preferences, such as price regulation and ceilings on various expenditure for housing.

The Ministry of Finance states that they have assumed that Finansinspektionen has the legal support required to apply existing macroprudential supervision tools. Given that Finansinspektionen in light of the work on amortisation requirements does not see clear legal support, the Government is now preparing proposals on the issue. The Government considers that it important to secure broad political consensus on a coming proposal.

Stability aspects of low interest rates

The Secretariat of the Stability Council presented work being conducted by the Secretariat, the Riksbank and Finansinspektionen that highlights some of the risks of the low interest rate environment. The effects of low interest rates include an increase in indebtedness, a rise in asset prices and high valuations of housing and equity, with heightened risk of a price fall. Another risk is that life insurance companies will be more vulnerable, an effect that may be strengthened by the Riksbank's purchase of government bonds. Life insurance companies' commitments have a long maturity and fixed rates and their capacity to manage interest rate risk is limited by a shortage of borrowers who want to opt for fixed interest with long maturities; in other words, there is a lack of duration in the financial system.

A long period of low interest rates could lead to a build-up of stability risks that may materialise when interest rates rise.

The Riksbank pointed out that there is expansionary monetary policy throughout the world, and it is carefully monitoring the effects this may have on financial markets. The European Systemic Risk Board (ESRB) is also working on the effects of the low interest rates. The Riksbank considers that it is positive that Finansinspektionen is monitoring developments in life insurance companies. The Riksbank is responsible for monetary policy and the inflation target is in focus. However, there are potential negative side-effects of the policy being pursued and Finansinspektionen has a major role to play in dealing with them. The Riksbank buys government bonds for the purpose of depressing market interest rates; the effects of this need analysis. The Riksbank considers

that so far it is working well. The expansive monetary policy means that liquidity is generally good, but the measures may have consequences on some sub-markets.

The National Debt Office stated that liquidity in the government bond market is currently good. However, there is a risk of poorer liquidity in future, i.e. impaired possibilities of converting government securities, in that an increasing proportion of the outstanding stock of these is held by actors that do not trade in their securities. This includes the Riksbank, which will soon hold about one third of the stock.

Finansinspektionen noted that there are major forces in operation at global level. The global credit expansion can be expected to continue, which is part of the challenge for macroprudential supervision.

The Ministry of Finance noted that these are interesting and important matters. Discussion of this issue can be continued in the Preparatory Group that prepares the Stability Council's meetings.

The role of the authorities in connection with bank recovery and resolution

The Stability Council Secretariat presented the ongoing work on the different roles of authorities and the Government in the new framework to be introduced through the Resolution Act on 1 February 2016. The Secretariat noted that a high degree of collaboration and exchange of information is required for smooth functioning of the processes. The Secretariat raised the issue that the role of the Stability Council in bank recovery and resolution needs to be investigated.

The Riksbank described its role as liquidity provider. Liquidity assistance has been given on various occasions previously, most recently in connection with the financial crisis in 2008–2009. Crisis and scenario exercises may be one way of obtaining increased knowledge of the role of authorities in connection with bank recovery and resolution as a result of the introduction of the new legislation.

One experience of the crisis is that there are frequent contacts between the authorities, with central banks and with the distressed bank. In reality things happen very quickly and contacts between authorities also need to take place outside the Stability Council. Consequently, it is of great importance that the authorities carry out regular crisis exercises.

The National Debt Office stated that the role of the Stability Council differs in relation to whether a crisis exists or not. In practice decisions must be made in real time. The authorities' resources must be gathered together in such a situation. That is what happened in the last crisis and

experience of this very close cooperation is good. The fact that the authorities at times were more or less working round the clock, side by side, proved to be an important success factor in crisis management. The National Debt Office shares the view of the Riksbank on the role of the Council and supports the proposal on crisis exercises.

The National Debt Office described the practical work that they and Finansinspektionen are now carrying out ahead of the introduction of the new framework for bank recovery and resolution. The National Debt Office has surveyed information needs, implemented systems development, produced templates for resolution plans, worked on proportionality assessments, drawn up a framework for MREL (minimum requirement for own funds and eligible liabilities), and the National Debt Office will send out a memorandum in early 2016 on the principles for application of MREL. The National Debt Office will be responsible for the resolution colleges for each of the four major Swedish banks. The National Debt Office has had a meeting with the resolution authorities and other relevant agencies in the countries where the major banks operate. A resolution manual will be drawn up. All in all, the National Debt Office assesses that the work has come a long way.

Finansinspektionen agrees with the Riksbank on the view of the Stability Council's role in a crisis. It would just be a formal detour. In a crisis the Council will meet more often for overall briefings, but the practical crisis management would be in closer collaboration between the agencies.

Preparations ahead of the introduction of the Resolution Act are a major joint project for Finansinspektionen and the National Debt Office, but the work is well under way.

A central part of the recovery plans is the banks' access to liquidity. In the plans the banks describe for example which assets they can pledge to the Riksbank. One condition for enabling Finansinspektionen to make an assessment of the plans is that there is clarity on the part of the Riksbank on how it regards liquidity assistance in crises. One way to obtain increased clarity is crisis exercises. If there is lack of legal clarity on the role of the Riksbank regarding liquidity assistance in crises, this may need to be investigated.

The Riksbank emphasised that what the Riksbank can do is quite clear in the current regulatory code. Under the Sveriges Riksbank Act it is the Riksbank that makes decisions on liquidity assistance.

The National Debt Office pointed out that not everyone is agreed that the rules for the Riksbank's liquidity assistance are clear and

unambiguous. For example, the issue is highlighted by the Financial Crisis Committee, which called for a review.

The National Debt Office did not share the Riksbank's assessment that there may be doubt as to whether an institution that continues to operate in resolution is solvent. Systemically important institutions will be resolved where necessary and continue to operate fully or partly. The National Debt Office considers that an institution in resolution, to the extent it continues to be operated by the State must reasonably be considered to be solvent. Against that background, and for as smooth a recovery and resolution process as possible, it should be clarified in advance that where necessary there will be access to liquidity assistance in such circumstances.

The Riksbank considers that continued dialogue is needed on this, and that some concrete questions need investigation; such as whether loans from the Riksbank can be exposed to debt write-down in resolution.

Structural changes in the banking market as a result of new regulations

The Stability Council Secretariat gave an account of structural changes in the banking market. As part of this work, meetings were held with a number of Swedish banks about how they assess that coming regulations will affect the banking sector, how the banks adapt their operations and which regulations the banks expect to affect their operations most. The banks themselves consider that the structural effect of the new regulations may be considerable, depending on how the regulations are formulated. According to the banks, the new regulations may lead to their adapting their operations to be higher risk, for example by selling low-risk assets and increasing risk-taking. Further, the banks believe that the risks will be moved away from the banks and instead be borne by the general public, through pension funds and other funds and the shadow banking sector, where there is less possibility of risk management. The amount of new regulation is considerable and it is difficult to estimate what the overall effect will be. The banks would like to see an analysis of this by the authorities.

The Riksbank points out that there are extensive analyses of the purpose of the regulations being introduced, for example in view of the banks in general not having functioned so well in the past 20 years. When there is new regulation there will always be a balance between short-term costs and long-term benefits. The banks have had too many degrees of freedom in their internal models. A sufficiently high leverage ratio is necessary. The best thing is if the supervisory authorities tighten up the

risk-weighted capital requirements. A low leverage ratio requires considerably more regulation of other kinds.

Finansinspektionen considers that the effects of new regulation, such as a high leverage ratio, may be greater for Swedish banks than for banks in many other countries. One consequence will probably be that the banks take on more risk. Finansinspektionen is looking at different possible cases of how banks may handle new regulation. How banks act, and when, is an important question. It is good to avoid radical structural changes, for example in the form of assets being removed from the banks' balance sheets to a more market-based system, as the risks here are partly unknown. Finansinspektionen sees advantages to a risk-based capital requirement compared with a binding leverage ratio, but also sees problems with the internal models used by the banks. Finansinspektionen is therefore now reviewing the internal models.

The Ministry of Finance considers that it is positive to have an analysis that reports the effects of new regulation on the financial markets. The Government's view is that the banks' capital requirements should be steered by an approach that takes into account the risk in the banks' operations. When non risk-weighted capital requirements are introduced, the requirements should have appropriate calibration in the form of a safety valve, and not be the binding requirement. The Government considers that the agencies, on the basis of their respective remits, should consider which line should be taken in international negotiations.

§ 3 Future work

Ahead of the next meeting of the Stability Council on 7 June 2016 the Council's members will discuss a number of different questions. Apart from the questions they are already working on, during the spring the Council will intensify its work in the following areas:

- The role of the authorities in crises
- Structural changes as a consequence of new regulation, as well as capital ratios in the Swedish banking system

The National Debt Office sees the need for an even broader macro and equilibrium analysis, for example in the form of scenario exercises. The Chair agreed with this.

Finansinspektionen will also present proposals for measures in addition to an amortisation requirement that could be taken to dampen household indebtedness.

§ 4 Other questions

Nordic-Baltic crisis exercise in 2017

The Riksbank presented information about a future crisis exercise as part of the cooperation in the Nordic-Baltic Stability Group. The last time there was a major crisis exercise in this constellation was in 2007.

Finansinspektionen is positive to a crisis exercise. If the exercise is to be relevant for all participants it needs to take into account that the supervisory responsibility in Europe is partly with the Single Supervisory Mechanism, and responsibility for resolution with the Single Resolution Board.

Standard & Poor's rating of Swedish banks

The National Debt Office pointed out that Swedish banks, as the only banks in Europe, will continue to retain state aid in their credit rating with Standard & Poor's (S&P), despite implementation of the Bank Recovery and Resolution Directive. S&P says it bases its rating among other things on expectations that debt write-down will not take place to the same extent as in other countries. The National Debt Office underlines that in a future crisis debt write-down will be the main tool for handling major losses, just as in other countries. Only in very special circumstances will state aid measures be possible. The regulations do not allow otherwise.

The Ministry of Finance noted that the new Resolution Act for banks is expected to come into force on 1 February 2016. Sweden negotiated some flexibility in the Bank Recovery and Resolution Directive, which will be implemented in Swedish law through a Riksdag decision. However, there will be a number of steps before the flexibility is even theoretically possible to apply.