Memorandum

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Summary of proposals for amended provisions on collateral for credit at the Riksbank

The Riksbank lends money to banks and certain other participants (counterparties). To limit the risk of making losses on these loans, referred to as 'credit risk', the Riksbank requires the counterparty to pledge adequate collateral. The Riksbank itself assesses whether the collateral is adequate or not, but normally the Riksbank bases its decision mainly on the security's external credit rating.

Much of the collateral pledged by the counterparties is composed of covered bonds issued in Sweden. These securities currently have the highest possible credit rating by external rating agencies. It is the Riksbank's assessment, however, that there are certain structural risks and vulnerabilities associated with covered bonds that are not fully reflected in the credit ratings.

On numerous occasions, the Riksbank has pointed out that the large extent to which the banks rely on covered bonds in their liquidity reserves is unsatisfactory. If a large proportion of these bonds are owned by a small number of banks, there is a risk that the bonds will be difficult to sell in a crisis. This "cross-ownership" of covered bonds also gives rise to spillover effects within the banking system if the banks need to sell other banks' covered bonds to secure liquidity.

Added to this, the indebtedness of Swedish households has increased considerably over the last ten years. One reason is the fact that Swedish banks have had good access to wholesale funding at low interest rates. The fact that banks have been able to expand their lending so quickly depends partly on their use of covered bonds as a source of funding.

The extensive use of covered bonds by Swedish banks thus poses certain risks to financial stability. By extension, this also poses risks for the Riksbank if covered bonds are used as collateral for credit. To reduce these risks, the Riksbank proposes to tighten the terms and conditions for covered bonds used as collateral for credit at the Riksbank. The proposed changes may lead to better diversification of the collateral pledged to the Riksbank by counterparties for their borrowings, which can reduce the Riksbank's credit risks.

The Riksbank proposes four amendments to the terms and conditions for collateral for credit at the Riksbank:

- Firstly, it is proposed that covered bonds issued by the counterparty itself shall no longer be accepted as collateral for credit at the Riksbank. This is a return to the terms and conditions for collateral that applied before the global financial crisis hit the financial system in 2007.
- Secondly, the requirement for the lowest credit rating for securities to be accepted as collateral is proposed to be raised from the current A- to AA-.
- Thirdly, the introduction of a concentration-limit rule is proposed under which covered bonds, as a share of a counterparty's total collateral value, may amount to a maximum of 60 per cent.
- Fourthly, the introduction of a concentration-limit rule is proposed under which a maximum of 50 per cent of the share of a counterparty's collateral value that comprises covered bonds may consist of covered bonds from the same issuer.

Proposal for amended terms and conditions for collateral for credit at the Riksbank

The Riksbank proposes four amendments to the terms and conditions for collateral for loans at the Riksbank:

- Firstly, it is proposed that covered bonds issued by the counterparty itself shall no longer be accepted as collateral for credit at the Riksbank. This is a return to the terms and conditions for collateral that applied before the global financial crisis hit the financial system in 2007.
- Secondly, the requirement for a minimum credit rating for securities that are accepted as collateral is proposed to be raised from the current A- to AA-.
- Thirdly, the introduction of a concentration-limit rule is proposed under which covered bonds as a share of a counterparty's total collateral value may amount to a maximum of 60 per cent.
- Fourthly, the introduction of a concentration-limit rule is proposed under which a maximum of 50 per cent of the share of a counterparty's collateral value that comprises covered bonds may consist of covered bonds from the same issuer.

1. The Riksbank lends money against collateral

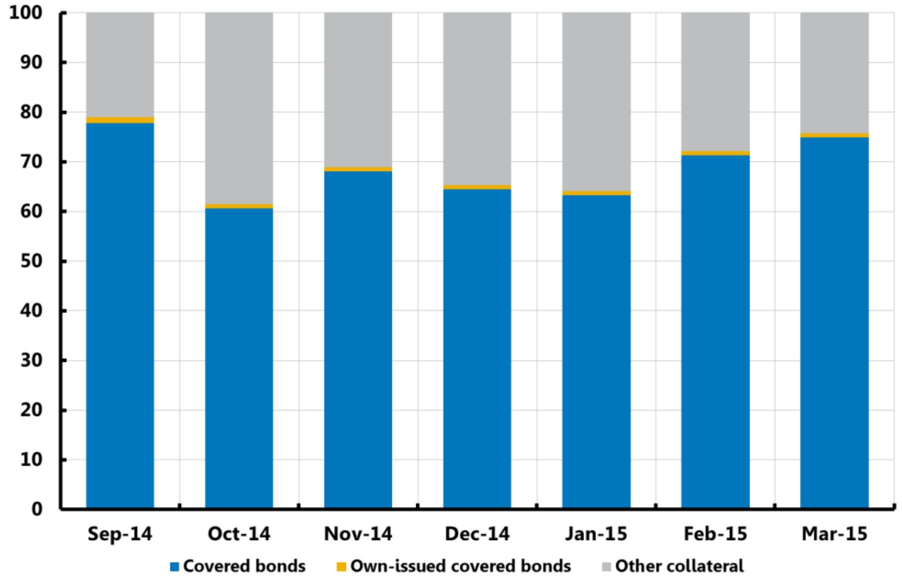
The Riksbank lends money to banks and certain other participants (counterparties) both during the day and overnight. To limit the risk of making losses on these loans, referred to as 'credit risk', the Riksbank requires the counterparty to pledge adequate collateral in accordance with the Sveriges Riksbank Act.[1] The Riksbank is constantly striving to minimise its own credit risk to protect the taxpayer from losses. On the other hand, the requirements on securities that may be pledged as collateral should not be so strict as to impair the efficiency of the financial system.

Covered bonds have high credit ratings but also pose certain risks

About 70 per cent of the total collateral pledged by banks and other participants to the Riksbank consists of covered bonds (see figure 1).

[1] See Chapter 6, Sections 5 and 7 of the Sveriges Riksbank Act (1988:1385).

Figure 1. Distribution of total collateral value, all counterparties
Per cent



Source: The Riksbank

Covered bonds generally have high credit ratings from external credit rating agencies. Normally, these ratings form the basis for the Riksbank's assessment of the credit risk linked to the counterparties' collateral. There are, however, certain structural risks and vulnerabilities associated with covered bonds, something which the Riksbank has highlighted on numerous occasions.[2] In light of this, the Riksbank has conducted a review of the provisions on collateral in the Terms and Conditions for RIX and Monetary Policy Instruments (the terms and conditions).[3]

Swedish banks have major holdings of covered bonds. The banks are covered bond "market makers" and therefore hold these securities in their trading books. They also hold large volumes of covered bonds in their liquidity reserves. Altogether, covered bonds compose almost two-thirds of the major banks' liquid securities denominated in Swedish kronor (SEK).

On numerous occasions, the Riksbank has pointed out that the large extent to which the banks rely on covered bonds in their liquidity reserves is unsatisfactory.[4] If a large proportion of these bonds are owned by a small number of banks, there is a risk that the bonds will be difficult to liquidate in a crisis. This "cross-ownership" of covered bonds also gives rise to spillover effects within the banking system if the banks need to sell other banks' covered bonds to secure liquidity. The large share of covered bonds in the banks' liquidity reserves is also the main reason for the major banks' low liquidity coverage ratios (LCR) in SEK.[5]

[2] See for example the *Financial Stability 2014:1*, Sveriges Riksbank and the article The market for Swedish covered bonds and links to financial stability, in *Economic Review 2013:2*, Sveriges Riksbank.
[3] The Riksbank's Terms and Conditions for RIX and Monetary Policy Instruments consist of an accession agreement, a master document and a number of appendices and sub-appendices. The terms and conditions for collateral for credit at the Riksbank are mainly regulated by Annex H4 Collateral Instructions.
[4] See the Riksbank's recommendation on LCR in SEK in *Financial Stability 2014:1*, Sveriges Riksbank.
[5] The LCR measures a bank's liquid assets in relation to a stressed cash flow for 30 days. According to the definition of LCR, government bonds are worth more than covered bonds when calculating a bank's liquidity

A covered bond is linked to certain selected collateral primarily in the form of mortgages.[6] The aggregate collateral for a covered bond forms a cover pool. Mortgages may only be included in the cover pool if the loan-to-value ratio is at maximum 75 per cent based on the market value of the underlying housing property. If housing prices fall, the loan-to-value ratio increases, which leads to a reduction in the banks' cover pool. This in turn has a negative effect on investors in covered bonds since they have less protection when the value of the cover pool decreases. A fall in housing prices would therefore probably make it more difficult for the banks to fund themselves.[7]

Added to this, the indebtedness of Swedish households has increased considerably over the last ten years. One reason is the fact that Swedish banks have had good access to wholesale funding at low interest rates. The fact that banks have been able to expand their lending so quickly depends partly on their use of covered bonds as a source of funding.[8]

The Riksbank can reduce its credit risk by tightening the terms and conditions for collateral for credit

The extensive use of covered bonds by Swedish banks poses certain risks to financial stability. Ultimately, this means risks for the Riksbank to the extent that the counterparties use covered bonds as collateral for credit at the Riksbank. The fact that the Riksbank deems covered bonds as eligible collateral for credit depends to a large extent on the high credit ratings that these assets normally have. But the Riksbank assesses that the risks associated with these bonds are not fully reflected in the credit ratings. The risk for the Riksbank of accepting covered bonds as collateral for its lending is therefore not fully reflected in the current terms and conditions.

The Riksbank can change these circumstances by tightening the terms for how covered bonds can be used as collateral for credit at the Riksbank. This can lead to better diversification of the collateral pledged by the banks for their loans at the Riksbank. This could not only reduce the Riksbank's credit risks but also decrease the concentration risks that the use of covered bonds poses to the banks themselves. Such a tightening of the terms and conditions may increase the liquidity premium for these securities, since this is partly determined by whether and on what conditions an asset can be pledged at the central bank. If this were to happen, it may also in the longer term increase the banks' costs for mortgage funding, contributing to a reduction in mortgage lending in the future and thereby reducing the Riksbank's credit risks still further.

2. Proposal for new terms and conditions for collateral for credit at the Riksbank

In the Riksbank's current terms and conditions for collateral under the Terms and Conditions for RIX and Monetary Policy Instruments, collateral is divided into two

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reserve. Since the largest proportion of Swedish banks' liquidity reserve consists of covered bonds, their liquidity reserve according to the LCR is limited.

[6] Mortgages refer to collateral in housing and credit against collateral in property or site leasehold for housing purposes. Other types of credit may also be included in the cover pool (such as credit against collateral in property or site leasehold for agricultural, office or commercial purposes, or equivalent foreign collateral, such as public-sector credit), but mortgages are, practically, the most important asset for covered bonds on the Swedish market.

[7] See *The Riksbank's commission of inquiry into risks on the Swedish housing market*, 2010.

[8] See the Riksbank's, Finansinspektionen's and Swedish National Debt Office's joint memorandum *Driving forces behind household indebtedness*, 2015.

categories: A and B. If collateral is placed in Category A, its use is unlimited while Category B comprises collateral that is subject to a concentration-limit rule. Securities that are subject to a concentration-limit rule cannot be used as collateral to an unlimited extent. According to the current terms, Category B includes own-name[9] covered bonds, securities with a credit rating of less than AA- but at least A- and own-name securities that are guaranteed by a central government or similar institution with unlimited powers of taxation.

According to the proposed new terms and conditions for collateral, the Riksbank will no longer accept collateral that is currently included in Category B. In addition, a new concentration-limit rule is proposed under which covered bonds may comprise a maximum of 60 per cent of a counterparty's total collateral value.

It is furthermore the assessment of the Riksbank that the covered bonds that a counterparty pledges as collateral at the Riksbank must be issued by more than one issuer. The Riksbank therefore proposes another limit aimed at reducing the concentration risks in its portfolio of collateral for credit. The limit means that a maximum of 50 per cent of the share of a counterparty's collateral value that comprises covered bonds may consist of covered bonds from the same issuer.

The proposed amendments will be introduced stepwise.[10]

- As a first step, the Riksbank will cease to accept collateral that is currently placed in Category B. At the same time, the minimum credit rating requirement will thereby be raised from the current A- to AA-. These changes will come into force in January 2016 at the earliest.
- In the second step, a concentration-limit rule is to be introduced under which covered bonds as a share of a counterparty's total collateral value may amount to a maximum of 60 per cent. This concentration-limit rule will come into force in May 2016 at the earliest.
- The third step will be the introduction of an additional concentration-limit rule under which a maximum of 50 per cent of the share of a counterparty's collateral value that is composed of covered bonds may consist of covered bonds from the same issuer. This concentration-limit rule will come into force in September 2016 at the earliest.

No amendment is proposed regarding the definition of covered bonds.[11] This means that the proposed amendments in the provisions do not differentiate between covered bonds issued by issuers domiciled outside Sweden, but within the EEA, and issuers domiciled in Sweden.[12]

The proposed changes apply[13] to collateral for intraday credit and monetary policy instruments[14], but not to general liquidity provision or emergency lending arrangements.[15]

[9] The term "own-name securities" in this consultative memorandum refers to securities issued by the party posting collateral itself or by an issuer closely associated with such party.
[10] The Riksbank will provide the relevant dates when it publishes the new terms and conditions on its website.
[11] Annex H4 uses the concept of "covered securities" which refer to securities that fulfil the requirements in Article 52.4 of Directive 2009/65/EC of the European Parliament and of the Council of 13 July 2009 on the coordination of laws, regulations and administrative provisions relating to undertakings for collective investment in transferable securities (UCITS).
[12] The Riksbank accepts securities issued in SEK, USD, GBP, DKK, EUR, JPY and NOK. The security's currency determines the applicable haircut.
[13] The proposed amendments will not have any effect on the certain intraday credit that is granted separately by the Riksbank to RIX participants in order to facilitate securities settlement in Euroclear Sweden.

Since the banking system currently has a structural liquidity surplus with the Riksbank, collateral is in practice only pledged for intraday credit.

Annex A to this document presents the revisions that are needed to be made in the Terms and Conditions for RIX and Monetary Policy Instruments in order to implement the amendments.

3. Proposed amendments compared to the current terms and conditions and the reasons for the proposals

3.1 Ban on the use of own-name covered bonds as collateral for credit at the Riksbank

3.1.1 Current rules

Under the current terms and conditions, as a general rule, the Riksbank does not accept own-name securities as collateral from counterparties. The Riksbank does however accept, to a limited extent, own-name covered bonds. These are subject to a concentration-limit rule (see 3.4), under which they may constitute a maximum of 40 per cent of the counterparty's total collateral value.

3.1.2 Proposed amendment

Own-name covered bonds will not be accepted as collateral for credit at the Riksbank. The amendment will come into force in January 2016 at the earliest.

3.1.3 Reasons for the proposal

In principle, the Riksbank considers that the use of own-name securities as collateral for credit should not be encouraged as it is likely that the value of these will decrease if the borrower encounters payment difficulties. The Riksbank’s credit risk therefore increases if own-name securities are used as collateral.

In December 2007, however, the Riksbank began accepting own-name covered bonds as collateral for credit at the Riksbank. The reasons for this was the prevailing global financial turmoil and the resulting problems with liquidity for banks worldwide. Since there is no longer any liquidity shortage in either the Swedish financial system or the Swedish banks, a return to the rules that applied before December 2007, i.e. to not accept any own-name covered bonds as collateral for credit at the Riksbank, is therefore justified.

Banks are increasingly subject to requirements to post collateral in accordance with various regulatory frameworks[16]. The use of own-name covered bonds as collateral

[14] Monetary policy instruments include fine-tuning transactions, standing facilities and repos. The effects of the proposed provisions on monetary policy repos are dealt with separately in section 4.5.

[15] To provide emergency liquidity assistance and when there are exceptional grounds to do so, the Riksbank may grant extraordinary loans, general liquidity assistance or emergency credit to an individual institution. Such measures are not covered by the terms that apply to the Riksbank's normal, day-to-day operations.

[16] As an example it can be mentioned that in the EU, the United States and other parts of the world, requirements are being set for the substitution of liquid collateral when clearing derivatives. The European rules on this can be found in Regulation (EU) No 648/2012 of the European Parliament and of the Council of 4 July 2012 on OTC derivatives, central counterparties and trade repositories (EMIR). Further extensive principles for requirements for liquid collateral for uncleared derivatives are being developed by the Basel Committee on Banking Supervisions (BCBS) and the International Organisation of Securities Commissions (IOSCO).

within these regulatory frameworks is however limited. [17] In this context, if the Riksbank then were to continue to accept own-name covered bonds as collateral, it could mean that it would accept such collateral to a larger extent than other institutions. This could in turn result in that the composition of collateral posted at the Riksbank could change in an unfavourable way for the Riksbank. Such a development is not desirable, which is why this possibility ought to be removed.

Furthermore, it can be noted that own-name covered bonds may not be included in banks' liquidity reserves when calculating the liquidity coverage ratio (LCR).

3.2 Ban on own-name securities guaranteed by a central government or equivalent institution as collateral for credit at the Riksbank

3.2.1 Current rules

As specified above, the Riksbank does not normally accept own-name securities as collateral for credit. To a limited extent, however, own-name securities that are guaranteed by a central government or equivalent institution can be used as collateral under the current terms and conditions. These are subject to the same concentration-limit rule (see 3.4) that apply to own-name covered bonds, which stipulates that collateral that is subject to the rule may constitute a maximum of 40 per cent of the counterparty's total collateral value.

3.2.2 Proposed amendment

Own-name covered bonds guaranteed by a central government or equivalent institution will no longer be accepted. The amendment will come into force in January 2016 at the earliest.

3.2.3 Reasons for the proposal

The reasons apply equally to securities that are issued by the counterparty itself and are guaranteed by a central government as those reasons put forward in respect of own-name covered bonds: There is no longer any sign of a liquidity shortage in the Swedish financial system and these securities may not be included in the liquidity reserves when calculating the LCR (see 3.1.3).

3.3 The Riksbank does not accept securities with a credit rating of less than AA- as collateral for credit at the Riksbank

3.3.1 Current rules

The Riksbank currently accepts securities with a credit rating of less than AA- to a certain extent. These are covered by a concentration-limit rule (see 3.4), according to which collateral that is subject to such rule may constitute a maximum of 40 per cent of the counterparty's total collateral value.

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[17] See footnote 19.

3.3.2 Proposed amendment

Securities with a credit rating of less than AA- will not be accepted as collateral for credit at the Riksbank. The amendment will come into force in January 2016 at the earliest.

3.3.3 Reasons for the proposal

The main reason for the proposal to raise the minimum credit rating requirement is to reduce the Riksbank's own credit risk.

Under the current terms and conditions, securities with a credit rating of less than AA- are subject to the same concentration-limit rule as own-name securities that are either covered or guaranteed by a central government. According to the new proposal, the Riksbank will continue to have just one concentration-limit rule to regulate the composition of collateral among different asset classes. Since the proposed new concentration-limit rule allows for more collateral that is subject to the concentration-limit rule (60 per cent) than the current rule does (40 per cent), an unchanged credit rating requirement would allow for a greater share of the total collateral value to be made up of securities with a credit rating of less than AA- than is currently the case. To avoid providing the counterparties with an incentive to pledge more securities with lower credit ratings as collateral, the Riksbank proposes to no longer accept securities with a credit rating of less than AA-.

3.4 Introduction of a concentration-limit rule for covered bonds

3.4.1 Current rules

The Riksbank currently applies a concentration-limit rule for

(i) own-name covered bonds

(ii) own-name securities guaranteed by a central government or equivalent institution

(iii) securities with a credit rating of less than AA- (see Sections 3.1, 3.2 and 3.3 above).

Under the current concentration-limit rule, the collateral value of the securities subject to such rule may constitute a maximum of 40 per cent of a counterparty's total collateral value.

3.4.2 Proposed amendment

A concentration-limit rule is to be introduced under which covered bonds as a percentage of a counterparty's total collateral may amount to a maximum of 60 per cent. As a result of 3.2.2. and 3.3.2., the current concentration-limit rule is to be removed.

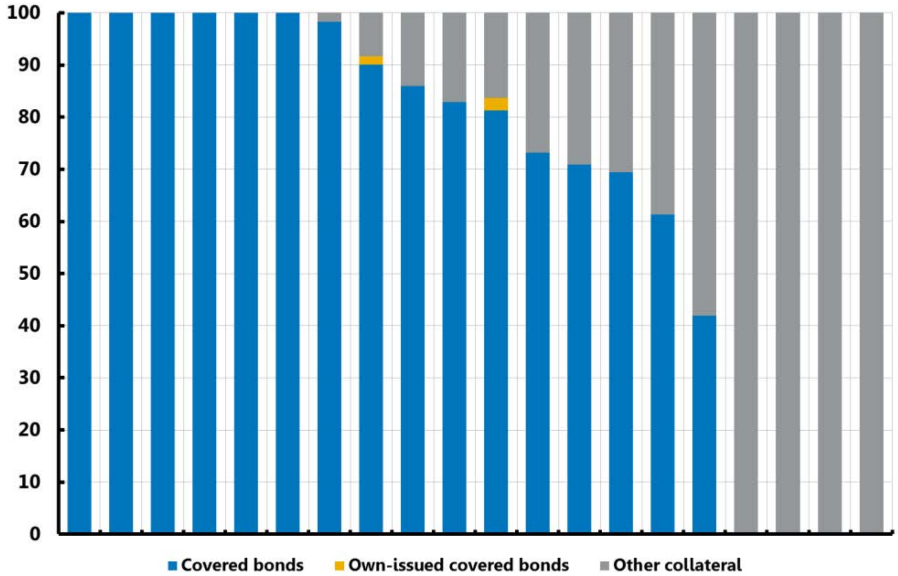
The concentration-limit rule is not applicable to intraday credit granted for securites settlement (see footnote 13).

3.4.3 Reasons for the proposal to introduce a concentration-limit rule

Covered bonds are currently the single-largest asset type pledged as collateral at the Riksbank (see figure 1 in section 1). There is also nothing in the current provisions that prevents counterparties from pledging only covered bonds as collateral. It is also common that counterparties do just that (see figure 2).

Figure 2. Distribution of total collateral value, per counterparty

Share of each counterparty's total collateral value at the Riksbank that consists of covered bonds, per cent



Note. Each bar represents a counterparty.
Source: The Riksbank

Swedish covered bonds currently enjoy the highest possible credit rating from external credit rating agencies. However at the same time the Riksbank assesses that the systemic risks associated with covered bonds are not fully reflected in the credit ratings. The Riksbank therefore deems that the collateral pledged to the Riksbank should be diversified to a larger extent. A concentration-limit rule may result in a reduction of the Riksbank’s credit risk exposure.

A concentration-limit rule can also lead to greater diversification in the banks' liquidity reserves by increasing the share of other assets than covered bonds in the reserves. This can also reduce the degree of cross-ownership (see section 1) of covered bonds. To the extent that the proposed amendments would lead to higher mortgage rates, credit growth for Swedish mortgages might also subside. All these side-effects can in turn reduce the systemic risk associated with covered bonds and hence alleviate the credit risk for the Riksbank in those cases where covered bonds are used as collateral.

It can also be noted that there is a limitation as to what proportion of a bank's total liquidity reserve may consist of covered bonds in the calculation of the liquidity coverage ratio (LCR).

3.4.4 Reasons for the proposal to set the concentration-limit rule at 60 percent

The concentration-limit rule should be set in such a way as to result in a sufficiently improved collateral quality in order to reduce the Riksbank's credit risk. At the same time, it must allow for efficient provision of credit to counterparties. The design of the concentration-limit rule should also take into account possible negative effects on, for example, the markets for government bonds and covered bonds, as well as the the conditions for pursuing monetary policy (see section 4).

About 70 per cent of the total collateral pledged by counterparties to the Riksbank consists of covered bonds (see figure 1 in section 1). In order to contribute to greater diversity of collateral in the form of Category A, and thereby reducing the Riksbank's credit risk, the concentration-limit rule should be below 70 per cent. How far under this level the relevant limit can and should be set will ultimately be a question of balancing the effects of the rule for individual banks and the market against the Riksbank's need to limit its credit risk. Four different concentration limits are evaluated: 70 per cent, 60 per cent, 50 per cent and 40 per cent.

Counterparties with a share of covered bonds that exceeds the relevant limit will be subject to a reduced credit limit (collateral value) at the Riksbank.[18] Assuming that counterparties choose to maintain their existing credit limit, they will have to pledge additional Category A collateral, i.e. collateral that is not subject to the concentration-limit rule. Such collateral comprises, for example, government bonds, municipal bonds and bonds issued by Kommuninvest that meets the requirements that must be satisfied in order to be acceptable as collateral for credit at the Riksbank.

To maintain their credit limit, the counterparties can either buy additional assets that can be pledged as collateral, or they can move collateral that they already hold to the Riksbank. The second option requires that counterparties already hold collateral for purposes other than for credit with the Riksbank. This may e.g. include collateral used in other payment systems than the Riksbank's, with central counterparties[19] or in bilateral OTC transactions.[20]

For the purpose of evaluating the possible effects on the markets for government bonds and covered bonds (see chapter 4) it is assumed that the counterparties choose to fully restore the credit limit that they had before the introduction of the limit. In addition, it is assumed that they do this solely by buying additional Swedish government bonds, which in turn is funded solely by selling covered bonds.

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[18] The proportion of the collateral at the Riksbank that is in the current Category B and will no longer be accepted is small in relation to the total collateral value that this analysis is only based on a limit rule for covered bonds.

[19]EMIR (see footnote 16 above) sets requirements as regards what type of collateral may be accepted by central counterparties when clearing derivatives. One noteworthy example is that own-name covered bonds may be accepted under certain circumstances. Many central counterparties does however stipulate in their own rules that their clearing members' own-name covered bonds are not accepted as collateral for the central counterparties' exposure towards the same member. From an international perspective, it is also uncommon that central counterparties accept Swedish covered bonds as collateral while some of the others, to a varying degree, accept foreign equivalents.[20] Bilateral OTC transactions refer to derivative transactions that are included and settled bilaterally without being cleared. Since such transactions are not covered by a clearing requirement, the exchange of collateral among the parties is made pursuant to market practice. Forthcoming legislation may result in an increase in exchange of collateral between derivatives counterparties.

[20] Bilateral OTC transactions refer to derivative transactions that are included and settled bilaterally without being cleared. Since such transactions are not covered by a clearing requirement, the exchange of collateral among the parties is made pursuant to market practice. Forthcoming legislation may result in an increase in exchange of collateral between derivatives counterparties.

Table 1 presents the counterparties' total additional need for Category A collateral at different levels of the concentration limit. The need ranges from SEK 22 billion, assuming a concentration limit set to 70 per cent, to SEK 94 billion with a limit of 40 per cent.

Table 1. Need for additional Category A collateral assuming different concentration limits, all counterparties

Concentration-limit rule: covered bonds as a share of total collateral value, per cent	Need for Category A collateral to restore credit limits, SEK billions
40	94
50	74
60	44
70	22

Source: The Riksbank

Table 2 presents the need for additional collateral in relation to the market value of outstanding government bonds. The value of the government bonds is measured in three ways. Firstly, as a sum of the market value of outstandning government bonds in all currencies. Secondly, only in SEK and lastly, in SEK excluding the Riksbank's completed and planned purchases.

With a concentration limit level set at 70 per cent, the need for additional collateral corresponds to 2 per cent of the market value in government bonds in all currencies (22 billion in relation to 1,097 billion). With a level of 40 per cent, the need corresponds to almost 15 per cent of the market value in government bonds in SEK, excluding the market value of the Riksbank's completed and planned purchases (94 billion in relation to 649 billion).

Table 2. The banks' estimated need for Swedish government bond purchases in relation to the market value of government bonds

Swedish government bonds	Market value, SEK billion	Limit rule (and volume) Amount as a percentage			
		40% (94 billion)	50% (74 billion)	60% (44 billion)	70% (22 billion)
All currencies	1,097	8.6%	6.7%	4.0%	2.0%
SEK only	809	11.6%	9.2%	5.4%	2.7%
SEK only excluding the Riksbank's purchases	649	14.5%	11.4%	6.8%	3.4%

Note. Market value of Swedish government bonds, public bonds in foreign currency and treasury bills as of 2015-08-31.
Sources: The Riksbank's calculations and the Swedish National Debt Office.

If the purchases of government bonds are funded solely by selling covered bonds, the counterparties would, assuming a concentration limit level of 70 per cent, need to sell covered bonds in an amount equal to 1.1 per cent (22 billion in relation to 1,972 billion) of the outstanding market value of covered bonds in all currencies. With a level of 40 per cent, the sale corresponds to 6.3 per cent (94 billion in relation to 1,485 billion) of covered bonds issued in SEK. (See table 3.)

Table 3. The banks' potential need to sell covered bonds in relation to the size of the outstanding volume of covered bonds

Swedish covered bonds, SEK billion	Outstanding volume, SEK billion	Concentration-limit rule (and volume) Amount as a percentage			
		40% (94 billion)	50% (74 billion)	60% (44 billion)	70% (22 billion)
All currencies	1,972	4.8%	3.8%	2.2%	1.1%
SEK only	1,485	6.3%	5.0%	3.0%	1.5%

Sources: The Riksbank's calculations and the Association of Swedish Covered Bond Issuers.

The Riksbank proposes that the concentration-limit rule be set at 60 per cent. This means that a maximum of 60 per cent of an individual bank's or other participant's total collateral value may consist of covered bonds.

About 70 per cent of the collateral that counterparties pledge with the Riksbank consists of covered bonds. A 60-percent concentration-limit rule may thereby contribute to increased diversification of the collateral pledged to the Riksbank since several counterparties solely or largely pledge covered bonds as collateral, and thus will need to rebalance their collateral portfolios with the Riksbank.

A similar concentration-limit rule to the one that is now being proposed is used when calculating the liquidity coverage ratio (LCR). This rule limits the proportion of a bank's liquidity reserve that may comprise covered bonds. The proportion amounts to 40 per cent according to the Basel III regulatory framework[21] and 70 per cent according to the European implementation of the LCR[22]. A concentration-limit rule of 60 per cent is within this interval.

Furthermore, it is the Riksbank's assessment that a concentration-limit rule set to 60 per cent can be introduced without negative implications for the efficiency of the payment system, on monetary policy, on liquidity in the Swedish government bond market or in the form of undesirable effects on bank funding and on other participants (see section 4). If the concentration-limit rule were to be set lower, there might be a risk of the need for Category A assets being substantial in relation to the outstanding volume of government bonds.

3.5 Introduction of a concentration-limit rule for covered bonds from the same issuer

3.5.1 Current rules

There is no equivalent concentration-limit rule in the current terms.

[21] See the Basel Committee's capital requirement standards "Basel III: A global regulatory framework for more resilient banks and banking systems" and Finansinspektionen's regulations FFFS 2012:6.
[22] Commission Delegated Regulation (EU) 2015/61 to supplement Regulation (EU) No 575/2013 of the European Parliament and the Council with regard to liquidity coverage requirement for Credit Institutions.

3.5.2 Proposed amendment

The share of a counterparty's collateral value that is composed of covered bonds may consist of a maximum of 50 per cent covered bonds from the same issuer.

The concentration-limit rule is not applicable to intraday credit granted for securites settlement (see footnote 13).

3.5.3 Reasons for the proposal to introduce a concentration-limit rule

Currently, all Swedish covered bonds have the highest credit rating possible. If there were to be differences in credit ratings, although all the securities were still to be accepted as collateral for credit at the Riksbank, this could, in the absence of the proposed limit, lead to changes in the composition of collateral pledged to the Riksbank that would not be favourable to the Riksbank.

It is therefore the opinion of the Riksbank that a counterparty's pledged collateral shall not only be diversified among different asset types but also among several issuers. This can lead to better diversification of the collateral pledged to the Riksbank by the banks for their loans, which in turn can alleviate the Riksbank's credit risks.

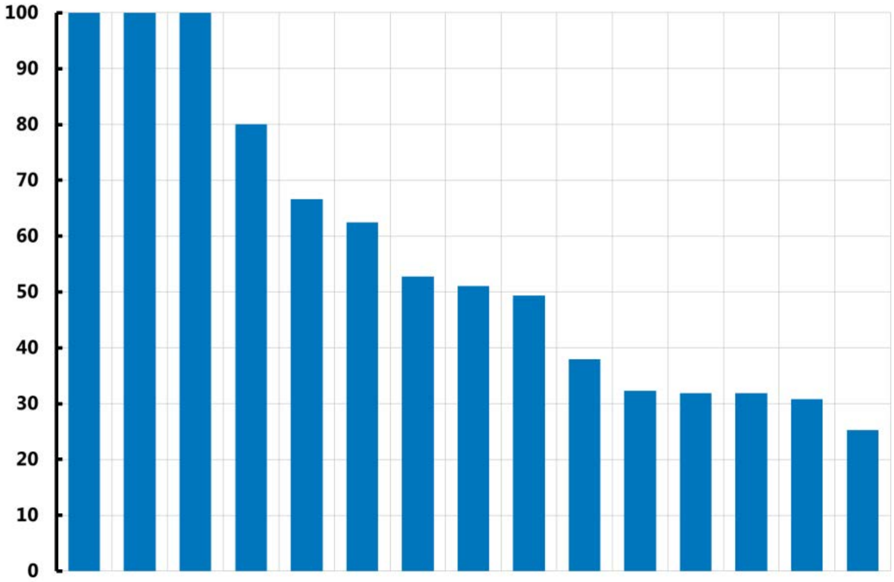
3.5.4 Reasons for the proposal to calibrate the concentration-limit rule to 50 percent

Under the current provisions, it is permitted to pledge covered bonds from the same issuer as collateral. The proposed concentration-limit rule means that a counterparty's collateral value consisting of covered bonds must be comprised of covered bonds from at least two issuers.[23]

Figure 3 shows the share of each counterparty's collateral value that consists of covered bonds issued by the largest individual issuer.

[23] If a bank has covered bonds from one issuer only, the collateral value of the covered bonds will be zero at the Riksbank.

Figure 3. The single largest issuer of covered bonds as a share of total collateral consisting of covered bonds, per counterparty
Per cent



Note. Each bar represents a counterparty.
Source: The Riksbank

4. Impact assessment

Pursuant to the proposed amendments, the Riksbank will no longer accept collateral that, under the current provisions, are included in Category B. Such collateral currently composes only a very small portion of the counterparties' total collateral value (credit limit). The impact on the collateral value by making the current Category B collateral ineligible is therefore limited. The proposed amendment is assessed to not have any negative impact.

The concentration-limit rule that prohibits the pledging of covered bonds from only a single issuer is deemed not to have a significant cost-impact on counterparties because those that are affected by the rule are assumed to be able to diversify their holdings of covered bonds without incurring significant additional costs. Moreover, as described below, counterparties often hold additional collateral used for purposes other than as collateral with the Riksbank and which, if necessary, can be moved to the Riksbank.

The concentration-limit rule for covered bonds issued by a single issuer is based on the percentage of the collateral value which consists of covered bonds rather than the percentage of the counterparty's total collateral value. For this reason, the limit can affect counterparties that in relation to their total collateral value only have a small portion of covered bonds, if such portion is characterized by a high-enough concentration to a single issuer. However, in such instances, where the portion of covered bonds is small, the impact of the proposed contration-limit rule will not be significant from a cost perspective.

Sections 4.1 to 4.7 describes the Riksbank's impact assessment of a 60-percent concentration-limit rule for covered bonds. The calculations are based on the assumption that counterparties choose to increase holdings of Category A collateral so as to maintain the collateral value at the same level before and after the introduction of the concentration-limit rule. It is further assumed that counterparties fund purchases of additional collateral in Category A solely by selling corresponding holdings of covered bonds.

The estimated need for additional collateral in category A for all counterparties under a 60-percent concentration-limit rule amounts to SEK 44 billion (see Table 1). The four major banks[24] account for the majority of this.

In practice, it may not be necessary to purchase any additional collateral in order to maintain the collateral value. Instead, the value can, in many cases, be maintained by moving collateral, which the relevant counterparty already hold elsewhere, to the Riksbank. Counterparties can also choose to only partially, or even not at all, to maintain their collateral value.

The impact assessment in the following sections covers the proposals' impact on banks, the payment system, the markets for Swedish government bonds and covered bonds, the effects on monetary policy, on the Riksbank's risk exposure and other market participants.

4.1 Little impact on the banks

The outstanding volume of covered bonds issued by Swedish issuers amounts to about SEK 2,000 billion. Most of the demand for covered bonds comes from other market participants than banks, such as insurance companies and pension funds. These are not covered by the Riksbank's terms and conditions for collateral. The proposed amendments' impact on banks' ability to obtain funding is therefore assessed to be low.

The major banks' holdings of covered bonds amounts to nearly SEK 500 billion. If the major banks are selling covered bonds in correspondence with their need for additional Category A collateral, this would only amount to a small part of their total holdings of covered bonds, as counterparties' overall need for further collateral amounts to only 44 billion, out of which the major banks account for a majority. The impact on banks' total holdings of covered bonds is therefore expected to be limited under the proposed amendment.

At the same time, the major banks' average LCR in Swedish kronor would increase from the current 73 percent to 82 percent as a result of the amended provisions and in light of the described rebalancing described above. The reason for such increase is that government bonds, from an LCR perspective, are worth more than covered bonds in the calculation of a bank's liquidity reserve.

4.2 Efficiency of the payment system is not expected to be affected to any great extent

To facilitate the ability of counterparties to make payments, the Riksbank can provide credit during the day, known as intraday credit. Since the credit is only granted

[24] Handelsbanken, Nordea, SEB and Swedbank.

against adequate collateral, the counterparties need to pledge collateral amounting to at least their daily need for intraday credit.

The value of the counterparties' collateral is estimated to exceed the value of payments that the counterparties perform even after the proposed amendments have been introduced (see Table 4).

Table 4. Credit limits compared with daily intraday credit, all counterparties

Average over the period Sep 2014 - Mar 2015	All counterparties, SEK billions
Credit limit under the current terms and conditions	292
Credit limit under the amended terms and conditions	227
Highest daily intraday credit during the period	145

Note. The values of all counterparties have been added together. These values have then been calculated as an average over the given time period.
Source: The Riksbank

In addition, the counterparties have the possibility to maintain their credit limit at current levels before the introduction of the concentration-limit rule by reallocating collateral from Category B to A. The need to reallocate is relatively small (see table 1).

The Riksbank therefore assesses that the efficiency of the payment system is not affected to any great extent by the proposed amendments.

4.3 Liquidity on the Swedish government bond market is not expected to be affected

As is illustrated in figures 1 and 2 and in table 1, individual banks may need to adjust their collateral as a result of the proposed amendments. This may in turn lead to an increased demand for Category A assets, e.g. government bonds. Assuming that the banks choose to *maintain* their collateral value and simultaneously meet in full the increased need for Category A collateral *solely* by way of purchasing government bonds issued by the Swedish government, they will only need to buy a relatively small share of the volume of the outstanding of government bonds (see Table 2).

The Riksbank therefore assesses that the liquidity in the Swedish government bond market will not be affected by the proposed amdendments.

4.4 The conditions for monetary policy will not change

The terms and conditions for credit at the Riksbank have some bearing on the implementation of monetary policy. This is particularly true during periods when the banking system has a structural liquidity deficit in relation to the Riksbank and hence a structural need to borrow against collateral. As a result of the current liquidity surplus, the banks instead have a structural need to make deposits in the Riksbank, which does not require any collateral. The exception is intraday credit, although this is of limited significance from a monetary policy perspective since the monetary policy transmission is based on the interest rate for loans on the overnight market where banks borrow from each other overnight without pledging collateral.

A tightening of the terms and conditions for the use of covered bonds as collateral may increase the liquidity premium for these securities, since this is partly determined by whether and on what conditions an asset can be pledged at a central bank. The interest rate for covered bonds could therefore rise as a result of the proposed amendments due to an increase in the liquidity premium. If the banks were also to buy Category A collateral and fund the purchases by selling covered bonds in the way described above, the interest rate for covered bonds may increase slightly more. This could in turn lead to higher mortgage rates with a reduced demand for mortgages as a result.

The effect on the covered bond market is considered to be minor, however, since the shift that may need to take place is small in relation to the total stock of Swedish covered bonds of about SEK 2,000 billion. If the counterparties at the same time buys government bonds, however, the interest rate on such government bonds may decrease. This should therefore only have a minor effect on the average interest rate between these two asset types.

The Riksbank therefore assesses that the conditions for pursuing monetary policy will not be affected by the proposed amendments. Neither is the proposal expected to influence the Swedish exchange rate to any great degree.

4.5 Implementation of monetary policy

Collateral subject to the proposed new concentration-limit rule, i.e. Category B collateral, cannot be accepted as an underlying asset in monetary policy repos.

Since the Riksbank, as a result of the bank system's structural liquidity surplus in relation to the Riksbank, does not currently offer monetary policy repos as a way of supplying liquidity, this will not have any short-term practical consequences.

If the banking system in the future were to have a liquidity deficit in relation to the Riksbank, the Riksbank may consider supplying liquidity in some way other than via monetary policy repos. If liquidity is instead supplied in the form of lending against collateral, the same terms as for the Riksbank's other types of credit would apply. Category B collateral would thereby be accepted, subject to the concentration-limit rule that applies to such collateral.

4.6 The Riksbank's risk exposure would decrease

The effects of the proposed amendment are considered to be positive for the Riksbank considering that it is expected that the amendment will result in a greater diversification of the collateral pledged by the banks for credit at the Riksbank. The proposal may also lead to reduced systemic risks on the covered bond market. This may ultimately lead to a reduction in the Riksbank's credit risk to the extent that covered bonds are used as collateral.

4.7 Other consequences

If the risk in a counterparty’s collateral portfolio being pledged with the Riksbank is reduced, this could instead lead to other market participants, to which the Riksbank's counterparties also provide collateral (such as central or bilateral derivative counterparties), having to bear the risk that the Riksbank wants to limit. It is difficult to assess the impact of this on the financial system as it is difficult to determine who these market participants may be.

It can also be noted that the proposed provisions that apply to covered bonds as collateral for credit will be stricter than those that apply in the central banks of Norway, Denmark and Finland at the time of publication of this consultation memorandum.

5. Continued process

The Riksbank will consider the comments from the referral bodies before deciding on the amendments. It is proposed that the amendments to the terms and conditions come into force step-by-step, with some amendments taking effect in January 2016 and others not before May 2016 and September 2016.

Such a gradual implementation of the proposed amendments means that, following a decision to adopt the amendments, these will be incorporated shortly after the referral period, but without entering into force until a later date. New terms and conditions will be published on the Riksbank website for each such amendments to the terms and conditions. A more specific date for entry into force can then be stipulated in the newly published terms and conditions.