Basis for decision

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DEPARTMENT: AFS and AFM

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Amended provisions governing collateral for credit at the Riksbank

Proposed decision

The Executive Board hereby decides that:

- the provisions governing collateral for credit at the Riksbank with respect in particular to the use of covered bonds be amended in accordance with what is stated in Annex 1 and
- the Head of the Markets Department, with the right to delegate to another person, be tasked with determining the more detailed wording of the amended provisions in the Terms and Conditions for RIX and Monetary Policy Instruments (Terms and Conditions), and with deciding an appropriate date for their entry into force.

Background

The Riksbank lends money to banks and certain other participants (counterparties). In order to protect the taxpayer from losses that may arise from the Riksbank's lending, the Riksbank requires each counterparty to pledge adequate collateral pursuant to Chapter 6, Section 7 of the Sveriges Riksbank Act (1988:1385). By only accepting collateral of a high credit quality and promoting a high degree of diversification, the Riksbank can reduce the risk of making losses on its lending, otherwise referred to as "credit risk".

The Riksbank looks primarily at a security's external credit rating, although it may if necessary consider other circumstances. If the collateral pledged at the Riksbank consists to a large degree of a single asset type, the Riksbank faces a concentration risk. To reduce this concentration, i.e. improve diversification, limit rules can be applied.

Covered bonds issued by Swedish issuers are currently given the highest possible credit rating by external credit rating agencies and are therefore accepted as collateral for credit at the Riksbank. There are, however, certain structural risks and vulnerabilities associated with covered bonds that make it unfavourable to be exposed to this type of security to such a high degree as the Riksbank currently is.

Furthermore, there is no longer any shortage of liquidity in the Swedish financial system as was the case during the 2008-2009 financial crisis, when the Riksbank applied less strict terms and conditions for collateral in order to make it easier for the banking system to borrow from the Riksbank.

In light of this, the Riksbank performed a review of the provisions governing collateral for credit at the Riksbank that are part of the Terms and Conditions. As a result of this review, the Riksbank formulated proposals for amendments to the provisions that mainly refer to the use of covered bonds as collateral. The proposals have been referred to relevant bodies for comment. A list of the referral bodies who have submitted comments or had the chance to do so can be found in Annex 2.

The comments of the referral bodies

During the referral period, Euroclear Sweden AB (Euroclear), the Swedish Bankers' Association and DNB Bank ASA, Sweden Branch (DNB) have each submitted comments on the proposals. Furthermore, Finansinspektionen and the Swedish National Debt Office (the Authorities) have submitted comments in a joint statement. The comments are available at the Riksbank (Dnr 2015-00700).

The Swedish Bankers' Association has no objections in principle to the proposed amendments but in its statement questions whether there is a concentration risk associated with Swedish banks' cross-ownership of covered bonds. The Association is furthermore of the opinion that the external credit rating of covered bonds takes systemic risks into consideration. Apart from this, the Association feels that the proposal will have no, or only marginal, effect on the setting of mortgage rates.

The Authorities, on the other hand, oppose all the proposals on the grounds that it is not appropriate to implement measures requiring banks to increase their government bond holdings or moving government bond securities used as collateral for other purposes to the Riksbank. At the same time, they consider that the need to reduce the Riksbank's credit risk is not clearly justified. According to the Authorities, the aim of the proposals is to influence financial stability. They therefore suggest that the proposals be analysed further and discussed in the Financial Stability Council. The Authorities do not, however, have any objections in principle to the Riksbank reverting to the same collateral requirements for credit as those that were applicable prior to the financial crisis.

Euroclear has submitted a recommendation for how the proposed amendments should affect credit at the Riksbank that is administrated by Euroclear.

In its statement, DNB says that it has no objections to the proposals.

A more detailed review of the referral bodies' comments on each proposal respectively is presented in Annex 1.

Considerations

The Riksbank constantly strives to limit its credit risk in order to protect the taxpayer from losses that can arise from the Riksbank's lending. By only accepting collateral of a high credit quality and promoting a high degree of diversification, the Riksbank can reduce its credit risk.

Much of the collateral normally pledged to the Riksbank comprises covered bonds issued in Sweden. The structural risks and vulnerabilities that are considered to be associated with these bonds mean that the Riksbank is exposed to systemic risk more

than necessary with regard to its assignment. The Riksbank can reduce its exposure to systemic risk by limiting the scope for using covered bonds as collateral.

The assessment that there are structural risks and vulnerabilities associated with covered bonds is partly based on the fact that banks rely on them to a considerable extent in their liquidity reserves. If a large proportion of these bonds are owned by a small number of banks, there is a risk that they will be difficult to sell in a crisis. "Cross-ownership" of covered bonds also gives rise to spillover effects within the banking system if the banks need to sell each other's covered bonds to secure liquidity. These risks can, in turn, have a negative effect on the value of covered bonds. The Riksbank does not therefore share the Bankers' Association's opinion that there is no concentration risk with regard to Swedish banks' holdings of covered bonds.

Covered bonds are linked to collateral above all in the form of mortgages and are therefore affected by the value of the housing to which the mortgages relate. It is therefore likely that a fall in housing prices would affect the banks' ability to fund themselves using covered bonds and that the value of the bonds could deteriorate. The use of covered bonds as collateral for credit poses risks for the Riksbank in the long term since the protection in the bonds decreases if the value of the underlying cover pool goes down or if bond prices fall.

The fact that Swedish banks rely on covered bonds to a high degree in their liquidity reserves and own each other's covered bonds, as well as these types of securities being dependent on developments on the housing market, therefore poses certain risks for the Riksbank if covered bonds constitute a significant share of the Riksbank's collateral. In light of this, it is appropriate for the Riksbank to tighten the provisions that apply to the use of covered bonds as collateral for credit at the Riksbank in order to improve the diversification of the collateral pledged by banks to secure their loans. By doing this, the Riksbank can prevent too much of the collateral currently pledged to the Riksbank by counterparties from being made up of covered bonds issued in Sweden. This can in turn reduce the Riksbank's credit risks. Secondly, it can also help reduce the concentration risks that the use of covered bonds poses to the banks and hence to the Riksbank, in terms of its own credit risk.

There are therefore grounds to no longer accept covered bonds as collateral to the same unlimited extent as applies under the current provisions, and to no longer accept securities that are currently accepted to a limited extent at all. Instead, covered bonds will be subject to a limit rule under which such securities may only constitute a certain maximum percentage of a counterparty's total collateral value. This percentage shall be set at 60 per cent in order to balance the Riksbank's interest in reducing its credit risk against the interest in maintaining the efficiency of the financial system. It is also deemed appropriate for a maximum of 50 per cent of the share of a counterparty's collateral value that is composed of covered bonds to be allowed to consist of covered bonds from one and the same issuer. Finally, the minimum credit rating requirement shall be raised in order to guarantee a high level of credit quality in all securities pledged as collateral for credit at the Riksbank.

All things considered, it is appropriate that:

- covered bonds issued by the counterparty itself be no longer accepted as collateral for credit at the Riksbank,
- the lowest credit rating for the securities to be accepted as collateral for credit at the Riksbank be increased from the current A- to AA-,

- a limit rule be introduced under which covered bonds as a share of a counterparty's total collateral value may be a maximum of 60 per cent, and
- an additional limit rule be introduced 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.

These provisions apply to collateral for intraday credit and monetary policy instruments, but not collateral for general liquidity assistance or emergency credit. Under the amended provisions, covered bonds can no longer be used as underlying assets in monetary policy repos.

In accordance with the applicable regulatory frameworks, it is the Riksbank's responsibility to assess what level of credit risk is acceptable when the Riksbank lends to counterparties. The amended provisions are expected to increase the diversification of the Riksbank's collateral for credit and thereby reduce its credit risk without affecting the efficiency of the payment system to any significant extent. In addition, they are expected to have only a limited effect on the banks' ability to obtain funding. Furthermore, it is the Riksbank's assessment that the implementation of monetary policy will not be affected.

The Riksbank also estimates that the amended provisions will only have a marginal effect on the liquidity on the market for Swedish government bonds since most of the counterparties' need for additional collateral can be satisfied by an increased holding of Riksbank Certificates, something which the Authorities also highlight in their joint referral statement.

The new provisions signify in part a return to the provisions that applied prior to the most recent financial crisis, when own-name covered bonds were not accepted as collateral for credit.

In light of these considerations, it is proposed that the provisions governing collateral for credit at the Riksbank be amended with regard in particular to the use of covered bonds. The import of these amendments is dealt with in detail in Annex 1.

In accordance with the provisions in the Instructions for Sveriges Riksbank, it is proposed that the Head of the Markets Department, with the right to delegate to another person, be tasked to determine both the more detailed wording of the provisions in the Terms and Conditions, and a suitable date for their entry into force. In connection with the wording of the amended provisions, the recommendation in Euroclear's referral statement shall also be taken into consideration.