Minutes of the meeting of the Council for Cooperation on Macroprudential Supervision held on 2 October 2012

Finansinspektionen and the Riksbank have held their second meeting within the framework of the Council for Cooperation on Macroprudential Supervision. Participants at the meeting were Martin Andersson, Per Håkansson and Martin Noréus from Finansinspektionen, and Stefan Ingves, Per Jansson and Mattias Persson from the Riksbank. The participants discussed the current situation and observed that unease on the financial markets has abated but that underlying structural problems still persist in a number of European countries. Swedish banks, however, currently have adequate access to market funding and their resilience is good. In addition, Finansinspektionen described the continued work on introducing a quantitative requirement for a liquidity coverage ratio, LCR, on 1 January 2013. The participants also discussed developments on the mortgage market and household indebtedness. In this context, Finansinspektionen's work on risk weighting for mortgages was also discussed, and the participants agreed that risk weights needed to be raised and that possible further measures, such as amortisation requirements, needed closer study. The participants also discussed Stibor, the Stockholm Interbank Offered Rate, and agreed that it is very important that a better regulatory framework for the banks should be in place by the end of the year. Other items discussed included the market for short-term financing in SEK and the banks' encumbered assets.

Swedish banks remain resilient

Prior to the summer, Finansinspektionen and the Riksbank assessed that Swedish banks had good resilience to poorer economic development in Sweden and abroad. The authorities' joint assessment at that time was that the greatest risk to financial stability in Sweden was posed by developments in the euro area and the resulting unease on the financial markets. The participants could now note that unease on the financial markets has abated since these assessments were made. This can be mainly traced to statements by political decision-makers in the EU and by the ECB during the summer and early autumn, which are believed to have increased clarity about how the crisis in the euro area can be handled. At the same time, the underlying structural problems of weak competitiveness, weak public finances and a weak banking system in a number of countries have not been solved, and there are also indications of future weak international macroeconomic development. Hence it can be assumed that the improved mood among financial market agents is due to expectations of public measures, rather than to actual improvements; therefore, as long as the underlying problems are not dealt with, considerable risks remain of renewed growth in unease in the financial markets. This continues to constitute the greatest threat of disruption to the Swedish financial system. The Council participants also noted that in a slightly longer-term perspective there is a risk that a deep and persistent recession in the euro area could have a negative impact on the economy in Sweden, the other Nordic countries and the Baltic countries, which in the long run could pose risks to stability in the Swedish financial system.

Even in light of these risks, it is the participants' assessment that the resilience of Swedish banks remains good and that at present they have good access to market funding. In this context, the authorities welcomed in particular the fact that the four major banks have strengthened both their capital adequacy and their liquidity buffers since the Council met in February this year. The solvency of life insurance companies also improved during the period, following the introduction of a discount rate floor before the summer.

Other macroprudential supervision issues

The European Systemic Risk Board's (ESRB) recommendations on dollar funding and lending in foreign currency

The Council participants discussed the ESRB's two recommendations concerning the European banks' dollar funding and lending in foreign currency. At the previous meeting of the Council the authorities noted that the ESRB's recommendation on dollar funding is highly relevant to Sweden as there is a significant liquidity risk in foreign currency, particularly in US dollars, in the Swedish financial system. The authorities found the ESRB's recommendation on lending in foreign currency to be important in light of previous Swedish experiences – both from the Swedish crisis in the 1990s and from the crisis in the Baltic countries – of the risks that lending in foreign currency pose to financial stability. Finansinspektionen described its continued work on the implementation of these recommendations. Finansinspektionen's assessment is that these recommendations will be complied with. The participants were in agreement that the matter should also be raised at the next Council meeting in February 2013.

Introduction of a Liquidity Coverage Ratio (LCR)

Finansinspektionen presented the plans to introduce a quantitative requirement for the liquidity coverage ratio (LCR) both in aggregate and separately in the euro and the dollar starting from 1 January 2013. At this meeting, Finansinspektionen said that the work of drawing up regulations is continuing as planned and presented the consultation feedback received. The board of Finansinspektionen will discuss the regulations and make a decision concerning them later in the autumn.

It is the view of both Finansinspektionen and the Riksbank that the introduction of a binding liquidity coverage ratio is key to strengthening resistance to short-term liquidity stress in the Swedish financial system and for dealing with the risks inherent in the financial structure in Sweden. The introduction of such requirements means that banks must maintain sufficient liquidity reserves to be able to handle short-term outflows in stressed situations. The participants agreed, additionally, that transparency regarding the liquidity coverage ratio is desirable and helpful, since it boosts resilience in the financial system.

Implementation of Basel III at EU level and stricter requirements for Swedish banks

Work is now in progress in the EU to incorporate the Basel III rules, including those on banks' capital adequacy requirements, into EU law. At the meeting the participants discussed how negotiations between the European Council and the European Parliament on proposed new capital adequacy rules are progressing. In Sweden, the question of higher capital adequacy requirements for Swedish banks is being prepared within the Ministry of Finance. Finansinspektionen and the Riksbank noted at the meeting that the assessment remains that the capital adequacy requirement for the big four Swedish bank groups - Handelsbanken, Nordea, SEB and Swedbank – should be at least 10 per cent in Tier 1 capital from 2013 and 12 per cent from 2015, but that practical incorporation into Swedish law must be adapted to EU law.

Risks in the housing market, risk weightings and mortgage payments

Internationally, developments in the property market have often played a prominent role in financial crises. In several crises, there is a connection between property price development and indebtedness on the one hand and the depth of the crisis on the other. The participants had an overall, general discussion concerning the various risks associated with mortgage lending and the measures that may be relevant for managing them. One conclusion of the discussion was that the risks are also affected by circumstances outside the financial regulatory framework, such as tax rules, personal bankruptcy rules and the extent of the social welfare system. Consequently, the participants considered it important to have a holistic view in the analysis. Moreover, they found that developments in the Swedish housing market and increasing household debt, which have been observed by the European Commission, the IMF and the OECD, need to be monitored and carefully studied. Against this background, the participants discussed two specific issues in more detail:

Finansinspektionen's efforts to raise risk weightings for Swedish mortgages, and the fact that Swedish households make such small mortgage repayments.

At the last meeting of the Council, the Riksbank and Finansinspektionen noted that the risk weightings used by the banks in their internal models for calculating capital adequacy requirements for Swedish mortgages need to be raised. This is necessary, they believed, to strengthen the banks' resistance to future financial crises. During the year, Finansinspektionen has investigated various possibilities of increasing the capital adequacy requirement for mortgages, thereby increasing confidence in the banks' capital strength and also helping ensure that they will obtain market funding. Publication of a proposal on risk weightings for mortgages was planned for early summer 2012. The proposal has been delayed, however, inter alia because negotiations in the EU on new capital adequacy rules are not finished, and the resulting uncertainty which this implies for Finansinspektionen's ability to introduce increased risk weightings through regulations. The participants noted at the meeting that it is important that the method to be used is transparent, regardless of whether it is applied via regulations or supervision. Finansinspektionen further described its continued work on risk weightings for Swedish mortgages, focusing on the method for the increase which the authority is developing.

The Council also discussed the development of household loan-to-value ratios, with special focus on how households decide to pay off their mortgages. It was noted that the loan-to-value ratio for new mortgages has fallen since the introduction of the mortgage ceiling. At the same time, there is movement towards longer mortgage repayment periods for new mortgages and greater interest-only components for the part of the mortgage that is below the mortgage ceiling, which is partly an effect of the mortgage cap. The participants discussed current mortgage repayment behaviour and found that both its consequences and possible measures – such as amortisation requirements – need to be investigated more closely. There will be an opportunity during the Finansinspektionen's mortgage survey, which will be conducted during the autumn, to examine this issue in more depth. Along with this, there can also be an assessment of compliance with the recommendation issued by the Swedish Bankers' Association that mortgage holders should repay the part of the mortgage that exceeds a 75 per cent loan-to-value ratio. The participants agreed to discuss these issues at the next meeting of the Council in February 2013.

The Swedish reference rate for the interbank market

The Council discussed the Stibor (the Stockholm Interbank Offered Rate), which is the most important reference rate on the interbank market in Swedish kronor. The Stibor has great impact on interest rates and capital allocation in society, since it is the reference rate for a large number of loans and financial contracts. Reference rates around the world have been under discussion since the onset of the financial crisis in 2008. In some cases, the handling of reference rates has been called into question and scrutinized: the LIBOR in the UK, for example, is now the subject of an extensive review. The Riksbank gave a brief account of its on-going internal analysis of the Stibor and of the investigation being carried out by the participating banks. The Council noted that there is nothing at present to indicate that the Stibor has been manipulated. There are, on the other hand, shortcomings in the way interest-rate setting is organised, and transparency concerning this is inadequate. In the long run this may undermine confidence in the Stibor. The participants agreed that it is very important that a better regulatory framework for the banks is in place by the end of the year. This framework should be marked by greater transparency and openness and should clarify responsibility for, and the supervision and governance of, interest-rate setting. Above all, the framework should also be adapted to the international guidelines for reference rates that are being drawn up, although this adaptation should take Swedish circumstances into account. Finally, the participants noted that it cannot be ruled out that more far-reaching changes will be needed in the slightly longer term, including assessing the need for supervision and regulation by public authorities.

Short-term funding in SEK

In the status assessment it was noted that the Swedish banks currently have good access to funding, which is partly acquired on the international funding markets. This is one of the strengths of the Swedish banks and the Swedish financial system. At the same time, however, the participants also noted that for their short-term funding in Swedish kronor, the banks have come to increasingly rely on access to markets in foreign currencies which are subsequently exchanged for Swedish kronor. One consequence of this is that the market for bank certificates in Swedish kronor has declined in recent years and is now very small. The Council discussed whether it is a problem that this market is so small or whether it would become a problem if it became even smaller. Generally speaking, banks' access to several different sources of funding is an important element of high resilience. It was also noted that dependence on short-term funding, in part, is being dealt with through present and forthcoming requirements concerning the management of liquidity risks. In conclusion, the participants believed that the question of the need for a liquid market in bank certificates in Swedish kronor should be the subject of further study, and that such a market could also help boost resilience in the Swedish banking system.

Encumbered assets

The question of asset encumbrance was also discussed by the Council. When banks fund their operations they do so partly by encumbering, or pledging, assets, which is sometimes required to obtain funding and is sometimes done to obtain less expensive funding. This happens, for example, when the banks enter into derivative contracts or repos and issue covered bonds. The participants noted that in international terms, Swedish banks have a relatively high degree of encumbered assets. This is a natural consequence of the fact that the banks fund a large part of their mortgage lending using covered bonds, which grant the bondholder a pledge in a specific pool of mortgages, as well as of their business model, under which encumbered mortgages remain on their balance sheets. This model has advantages from a stability viewpoint. When banks retain mortgages on their balance sheets, incentives for sound lending practices are created. The market for covered bonds has also proven relatively robust even when the financial system is highly disrupted. However, extensive asset encumbrance may contribute to the development of liquidity risks for the Swedish financial system, since in a stressed situation banks have fewer free assets to pledge as collateral, at the same time as the demand for collateral for existing debts rises. Moreover, a high degree of encumbrance may transfer risk to the taxpayers, because the deposit guarantee system cannot recover as much from a bankruptcy estate, something which is not currently taken into account in the fee which the banks pay into the system. Due to the government safety net, both the banks themselves and the investors have weak incentives to take into account how the encumbrance of assets affects liquidity risks and credit risks, respectively. This creates a possible breeding ground for an exaggeratedly high level of encumbrance. The participants in the Council noted that greater transparency regarding which, and how much, of the banks' assets are encumbered may help reduce the negative effects of encumbrance. The participants also found it desirable that the banks themselves should take the initiative of beginning to publish information that makes it possible for external parties to assess their level of encumbrance.