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Finansinspektionen's view on financial stability and the risks for financial imbalances

Thank you for the invitation to present FI's view on financial stability and discuss the challenges we see before us.

Finansinspektionen has two stability assignments. The first is to promote stability in the financial system. The second is to counteract financial imbalances on the credit market, which is often referred to in general as "macroprudential supervision". These objectives are closely related. Crises in the financial system in particular can lead to a credit crunch and other shocks to the credit market. FI's primary assignment is to work to prevent such developments by enhancing the resilience of the financial system. One objective is to ensure that the financial system can continue to provide the economy with loans and other services even if exposed to shocks. The focus here is on the resilience of the financial firms and markets. FI's assessment of the situation in this respect can be summarised with one word: satisfactory.

The fact that the financial system's resilience is satisfactory is – naturally – satisfactory in and of itself. However, financial imbalances that threaten economic stability can arise even if financial firms are resilient. Since FI was assigned the express task of counteracting financial imbalances – and even before that in practice through the mortgage cap – the focus has been on the vulnerability related high household debt. In our view, the situation related to household debt is not satisfactory. As an additional measure to strengthen resilience in the household sector, FI has proposed a stricter amortisation requirement.

I will start with a quick overview of the current status of stability in the financial sector. This will then segue into the motives behind our proposal to introduce a stricter amortisation requirement. I will conclude by presenting FI's view on stability in the financial system, with an emphasis on the banks' capital and liquidity buffers.

The current state of stability

The state of the Swedish economy is unprecedented in that strong growth and falling unemployment are accompanied by extremely low interest rates. This combination creates an environment that fosters rapid increases in house prices and debt as well as fundamental imbalances on the housing market. This contributes to the build-up of vulnerabilities. This means that households and the Swedish economy will be less equipped to handle a downturn in the economy. This downturn will come, sooner or later, and when it does it may be aggravated by a significant fall in house prices and a high level of debt among households. The Riksbank is also facing limited opportunities to ward off such a downturn through lower interest rates since policy rates are already low. This justifies action from FI, which I will return to in a moment.

The level of the interest rates creates challenges in multiple areas. For example, FI believes that the market for commercial properties requires more attention. Prices on commercial properties have risen rapidly over the past few years, in part as a result of the low interest rates and thus the low financing cost of real estate purchases and investments. Experience shows that the prices on such properties are both volatile and cyclical. Commercial real estate in both Sweden and other countries has often played a central role in major financial crises. The crisis in the 1990s was triggered by a fall in the prices of commercial real estate, and the majority of the banks' credit losses came from there. FI has not observed any signs that the banking system as a whole is taking on too much risk in its lending to real estate companies. The lessons from the crisis in the 1990s appear to be strongly rooted. Banks are focusing on repayment capacity and cash flows instead of the property's market value. The credit risks are therefore currently considered to be limited. However, FI has expanded its analysis of the commercial real estate sector and is following its development.

Interest rates also play an important role in the insurance industry. The low interest rates are weakening the solvency of life insurance companies, but the effect is being offset by strong growth on the stock market. The overall financial position of the life insurance companies therefore currently appears stable. Stress tests show that, in general, Swedish insurance undertakings are financially strong and can handle financial shocks. However, insurance undertakings are also facing challenges in the future if interest rates continue to be low, and in the long run it may be problematic for life insurance companies to fulfil their guaranteed obligations.

Household debt a cause for concern

But let me return to the area where there is immediate cause for action from FI: its assignment to counteract financial imbalances. As mentioned previously, the Swedish economy is facing unprecedented conditions. As far as I know, there is no other country with an independent monetary policy that is experiencing a combination of extremely low interest rates and strong economic growth. Together with a poorly functioning housing market and a tax system that promotes indebtedness, this has created a climate in which house prices and debt are growing rapidly. Over the past three years alone, house prices have risen by approximately 40 per cent.

FI has taken several measures to limit the risks posed by high household debt. We started with the mortgage cap, which was implemented in 2010. The aim of this measure was to protect households and counteract an unhealthy development on the credit market in which credit institutions use higher and higher loan-to-value ratios as a means of competition. The mortgage cap achieved its purpose and has broken the trend of increasing loan-to-value ratios. We then gradually raised the banks' capital requirements, both in general and for mortgages in particular. The purpose of these requirements was to ensure that the banks have margins that can manage potential loan losses and thereby lend to households and firms even during tougher times.

In June 2016 we implemented the amortisation requirement following approval from the Government. Our analyses show that households are buying less expensive homes, borrowing less and using more savings to finance the purchase of a home as a result of the amortisation requirement. They will also pay off their debt faster. This makes households more resilient and reduces the risk that many households will reduce their consumption at the same time, thus aggravating a future downturn in the economy.

Despite these measures, there are still risks. The percentage of new mortgage holders with large loans in relation to their income has also increased over the past five years. The amortisation requirement appears to have broken this trend, but there are still many households taking on loans that result in a high loan-to-income ratio. This is largely due to the fact that house prices have risen much faster than household income over the past few years. The development has meant that the loan-to-income in the stock of mortgage holders has increased. Since house prices are continuing to rise, this means that macroeconomic vulnerabilities are continuing to build.

In order to further increase the resilience of households, FI therefore intends to introduce a stricter amortisation requirement for new mortgage holders with high loan-to-income ratios, i.e. households that take on large mortgages in relation to their income. The proposal entails that households borrowing more than 450 per cent of their annual gross income must amortise one per cent a year in addition to the amortisation payments required under the current regulations. Based on the most recent mortgage survey, the stricter requirement would influence 14 per cent of new mortgage holders, i.e. those purchasing their first home, those buying a new home and those remortgaging in order, for example, to renovate. The stricter requirement can be in place relatively quickly since it falls under the current amortisation legislation. This reduces the need to take more drastic measures at a later date.

Households are expected to purchase less expensive homes, borrow less and amortise more as a result of the stricter requirement. It is generally acknowledged that measures of this type have a tangible impact on households in metropolitan areas since they generally borrow the most in relation to their income. However, they will also be hit the hardest in a future crisis. It is our assessment that the stricter requirement will increase households' resilience to macroeconomic shocks. It will also make it easier for young households in future generations to enter the housing market since it will slow the rise in house prices.

FI has been tasked with counteracting financial imbalances with the aim of protecting the financial system, households and the Swedish economy. Given the risks that are continuing to build up, FI takes the position that a stricter amortisation requirement is a well-balanced proposal that strengthens households' resilience to shocks. However, FI is not able to single-handedly resolve the growing vulnerabilities on the housing and mortgage market. The stricter amortisation requirement only affects new mortgage holders. In order to prevent rapidly rising house prices and debt from leading to major imbalances, measures are also needed in other policy areas.

Banks show satisfactory resilience

Let me conclude by commenting on FI's preventive work to strengthen the resilience in the banking system. A lot has happened in this area since the financial crisis, both internationally and in Sweden. FI makes the assessment that Swedish banks in general are demonstrating satisfactory resilience. They continue to report good profitability, low credit losses and high levels of capital in relation to the risks in their operations. They should manage to continue providing credit and other critical functions even during a serious recession.

FI has contributed to the high levels of capital by utilising the flexibility in the regulatory framework to set higher requirements. For example, FI applies a systemic risk buffer of 5 per cent and a countercyclical buffer of 2 per cent. FI has also raised the risk weights for mortgages and exposures to corporates in the banks' internal models. The requirements are structured in such a way that the banks' capital largely consists of buffers. In this way, a bank can carry credit losses without immediately needing to restrict lending, and financiers do not need to be immediately concerned that the bank will breach the minimum capital requirement and thus be entered into resolution. In a best case scenario, the bank can instead through well-prepared recovery measures restore its capital position and continue to conduct business.

Stress tests from the IMF, the European Banking Authority (EBA) and Swedish authorities indicate that Swedish banks are resilient to credit losses. Market participants also consider Swedish banks to be highly resilient, which is reflected in their strong credit ratings. They are also better capitalised than many of their European counterparts. And they have higher profitability. The fact that the banks are also strong in relative comparisons helps them have good access to funding.

The banks are also well above FI's requirements on liquidity reserves. The requirements are based on a bank having liquid assets so that it is able to manage on its own for a certain amount of time in the event there is no access to new funding. The Swedish requirements are stricter than those in the Basel Agreement. FI also has specific requirements on liquid assets in USD and EUR. The banks comfortably meet these requirements as well. The stress tests conducted by the IMF during its assessment of the Swedish financial sector in 2016 show that the buffers are sufficient for the banks to manage without external support even in serious scenarios.

Since 2016, we also have a new regulation for crisis management – resolution. The Swedish National Debt Office, which is responsible for resolution management, announced its requirement on bail-inable debt, which is higher than in many other countries. This emphasises the principle that losses must now be borne by the banks' creditors and not the state. This forces creditors to do more monitoring, which much like the high capital requirements limits the banks' opportunities for high risk-taking. Bail-inable debt also functions as an additional (latent) capital buffer that through resolution can be activated to cover losses and restore the affected bank's own funds so that the bank's crucial functions can continue to operate.

The development in Sweden has been affected by the major changes in the financial regulations that have been developed globally and within the EU. FI has opted in a number of areas to establish higher requirements than those set by the international agreement in order to manage the challenges unique to the Swedish banking market. This has been to the benefit of the Swedish economy and – in my opinion – the Swedish banks. By comfortably meeting the international requirements, the banks are able to fund themselves on favourable terms. This is an important reason behind their good profitability.

Leverage ratio requirement as a governance tool

The work on the regulatory framework continues at the international level. The Basel Committee is expected to present a final agreement in the near future. Negotiations are also ongoing within the EU on the Commission's banking regulatory package. FI has many opinions about the Commission's proposal. For example, we are opposed to limitations in the possibilities to use higher capital requirements for macroprudential purposes. FI would like to continue to be able to set higher requirements that are adapted to Swedish conditions, if they are considered justified.

Here, I would like to bring up a different part of the banking regulatory package: implementation of the leverage ratio. Also here, the effects on the share of buffers in the capital requirements play a central role and can affect how a bank reacts to losses. The requirement can also have more direct effects on banks' behaviour under normal conditions.

FI is of the opinion – as is the Government – that it is vital for the banks to be governed by *risk-based capital requirements*. Banks that take greater risks should hold more capital. Risks cannot be measured exactly, but they can be ranked. And banks' risk models can be used to determine their capital needs. This is the basis for the international regulatory work that FI supports. But the models must be managed with appropriate restrictions and under supervision. FI has reviewed in particular risk weights for exposures to corporates. We found that the assumptions the banks were applying in their models were not sufficiently prudent. FI has therefore ensured that the risk weights – and thus the capital requirements – were raised. It is necessary to continue to review these models.

The leverage ratio, in contrast, is independent of risk. It is influenced solely by the size of the bank's assets. Swedish treasury bonds (and claims on the Riksbank) have the same effect on the capital requirement as lending to newly established, high-risk companies.

As a restriction on banks with unusual business models or protection against grossly underestimated (and unidentified) risks in internal models, such a requirement can be valuable. But the leverage ratio requirement must be handled with care and reflection. If the requirement is set so high that it affects the banks' business decisions, they will start to think and act differently. The result can be decreased stability. One reason is that banks can benefit from selling assets with low risk and low margins, for example through the securitisation of mortgages. This raises the average risk level in the bank, but the capital requirement goes down. It also becomes possible to actively choose riskier assets without experiencing an increase in the capital requirement.

Another effect of a leverage ratio requirement is that it decreases the possibilities to use capital buffers in a crisis situation. FI's analyses show that already at a minimum requirement of 3 per cent as much as half of the capital buffers the banks have today are locked in.[1] In an interesting paradox, a higher leverage ratio leads to a drop in the amount of capital held by the banks that is flexible and can be used outside of resolution. This stands in direct contrast to the efforts of the regulatory framework to ensure that banks are able – and want – to continue to supply the economy with loans even during economic downturns.

FI stands behind high capital requirements and the possibility to go even further when required by national conditions. Even higher requirements may

1 See FI Analysis 7: Leverage ratio as a minimum requirement reduces banks' buffers (http://www.fi.se/sv/publicerat/rapporter/fi-analys/2016/fi-analys-7-bruttosoliditet-som-minimikrav-minskar-bankernas-buffertar/).

come from the final Basel Agreement. FI has no objections on principle to the more demanding capital requirements, but the risk-based system should be dominant even in the future. And the regulatory framework should allow for capital requirements with large buffers.

In the Basel Agreement, the leverage ratio requirement is described as a “backstop”. In other words, it should be a supplemental tool that becomes binding if a bank has a business model or internal models where the risk weights do not successfully capture the risks in a reasonable manner.

One can discuss if a minimum capital requirement that eats up buffers and quickly becomes binding in a downturn can really be considered a backstop, but right now that is more of a philosophical discussion. We must wait for the outcome of the negotiations within the EU. In any case, FI makes the assessment that neither substantive grounds nor the status of the EU negotiations support the introduction of a higher leverage requirement at a national level.

Satisfactory liquidity buffers
As I mentioned, the banks comfortably meet FI’s requirements on liquidity reserves. Tests using internationally accepted methods show that they can handle significantly higher levels of stress than those they experienced in 2008–2009. This serves as the foundation for our assessment that the situation is satisfactory.

Liquidity buffers aim to ensure that banks can manage shocks to their funding sources without needing external support. In other words, it is a type of self-insurance. FI takes the position that this insurance works better the more liquid the assets of the banks. We have therefore set specific requirements on liquid assets in USD and EUR. In a crisis, for example, German and US treasury bonds may be assumed to be the easiest to convert to funds for payment. The bank can then exchange from USD to the required currency, including SEK, if appropriate.

FI therefore believes that specific liquidity requirements in SEK would not strengthen the banks’ resilience. The real liquidity in the banks’ liquid assets would decrease from such a redistribution. For this same reason, FI also does not consider it to be appropriate to require banks to replace USD assets in their liquidity buffers with DKK or NOK.

It is perhaps possible to imagine an international crisis of such a scope that it becomes difficult to exchange USD for smaller currencies. But, it is inconceivable that such a crisis would not require strong intervention from authorities in Sweden and other countries. In other words, there is a limit to how far it is possible to demand that the banks be able to handle a crisis on their own.

This point has a broader significance. As a company, banks are special. Their operations are based on converting illiquid assets to liquid liabilities. This makes them highly sensitive to disruptions. But, at the same time, they perform an important service. This is why – to be clear – legislators have chosen to allow banks to exist.

But legislators have also realised that banks must be reined in by special regulations. They must be subject to requirements on capital and liquidity so they are resilient to losses and liquidity problems. And special supervision is required to ensure they comply with the rules. In addition, there must be rules in place to manage a bank that suffers losses that are so large the bank is not able to meet its commitments. In all of these areas – as mentioned – major changes have occurred since the financial crisis and even tighter regulations are pending. FI has had and will continue to have an opinion about *how* the changes are implemented, but the regulations are moving in the right direction.

However, it is not reasonable to pursue stricter regulations to the extent that banks can withstand *all types* of crises on their own. In some exceptional situations, the state must be prepared to step in. Legislators have also realised this and created institutions and a framework for handling such a situation.

We therefore have resolution authorities tasked with keeping crucial functions in a systemically important bank going even if losses are so large there is a shortfall in capital. Via the resolution framework, these regulations have been adopted at the EU level. They specify that the state will not bear these losses. Rather, solvency must be restored using other methods.

For the same reasons, central banks have been tasked with supporting solvent banks if their funding markets stop functioning and liquidity buffers prove to be insufficient. This assignment refers primarily to providing general liquidity support if funding markets are not functioning or many banks for whatever reason suffer from failing confidence that is not related to insufficient solvency. We saw this happen in 2008. Strong intervention from the central banks – supplemented by state guarantees – was necessary then and will be just as necessary if a similar situation arises. It is impossible for the banks to self-insure against a full-scale systemic crisis.

How liquidity support is to be handled in Sweden's case is a national matter. There is no EU regulation to rely on in the area. As noted even by the Committee on Finance, the Swedish rules for when and how liquidity support should be granted need to be clarified. It is therefore a central task for the Riksbank Committee to review these rules and thus clarify the Riksbank's responsibility within the area of financial stability.

Thank you. I look forward to the Committee's questions and the continued discussion.