



Financial Stability Council

**Minutes from the meeting of the Financial Stability Council held on 7
December 2016**

Summary

The members of the Stability Council discussed the stability situation. The financial system is functioning well at present, but there are both international and domestic risks. The international risks include weak global macroeconomic development, economic policy uncertainty, a weak European banking system and compressed risk premiums on financial markets.

The domestic risks are mainly linked to high indebtedness and high asset prices, due to low interest rates. Household indebtedness continues to increase faster than incomes. The Swedish financial system is large, interconnected and exposed to risks, due to high household indebtedness. The authorities also highlighted the fact that Swedish banks are dependent on market funding, which, together with long-term lending and short-term funding, creates liquidity risks.

Further, measures taken and the need for future measures were discussed. The authorities in the Stability Council are agreed that risks are building up regarding household indebtedness and that further measures may be required to dampen the growth of debt. One fundamental problem is the functioning of the housing market and incentives to incur debt.

The Council also discussed upcoming regulation and how the proposals may affect capital adequacy requirements for Swedish banks.

The work of the Stability Council has been evaluated and proposals for minor adjustments in working methods were discussed. During the autumn a scenario exercise was carried out under the leadership of the Stability Council, in which the new framework for banking crisis

management was tested. Lessons learned from the exercise were discussed at the meeting.

In connection with the meeting a Memorandum of Understanding (MoU) on cooperation relating to financial stability and crisis management was also signed. The MoU describes the authorities' remits, tasks and roles in promoting financial stability and in crisis management. The MoU replaces a previous MoU of 2009.

Ahead of the next meeting of the Stability Council on 12 June 2017, the Council members will continue to discuss several of the matters discussed at today's meeting, including household indebtedness and future capital requirements for the banks. The Committee will work together on scenario and crisis exercises.

Present:

Ministry of Finance

Per Bolund, Chair

Ulf Holm

Aino Bunge

Eric Ramstedt (point 3)

Finansinspektionen

Erik Thedéen

Martin Noréus

Henrik Braconier

Swedish National Debt Office

Hans Lindblad

Mårten Bjellerup

Tom Andersson

Riksbank

Stefan Ingves

Kerstin af Jochnick

Kasper Roszbach

Financial Stability Council Secretariat

Niclas Alsén

§ 1 Stability assessment

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

The Riksbank, Finansinspektionen and the Swedish National Debt Office presented their respective assessments of the stability situation for the members of the Council.

The Riksbank presented its stability assessment from the Financial Stability Report of 23 November. The message of the report is that the financial system is functioning well at present, but that it is vulnerable. The risks include weak global macroeconomic development, high indebtedness and high valuations due to low interest rates. The Swedish financial system is interconnected and exposed to risks resulting from the high level of indebtedness and the fact that the banks are dependent on market funding.

Around the world interest rates are low, which promotes increased risk-taking. Even if increased risk-taking is partly the purpose of the low policy rates, this may lead to excessive risk-taking. Assets may be overvalued and incorrectly priced, which may lead to increased vulnerability in the financial system. One risk is high housing prices, which are high in a historical perspective. This is mainly due to structural factors that restrict the supply of housing. In Sweden housing construction has been too low for a long time and the existing housing stock is not used effectively.

Earlier this year housing prices slowed down but they have now started to increase again and there are great risks attached to that. Since the election in the USA there has been a rise in long-term government bond yields. In the USA this was driven by a rise in inflation expectations as well as the nominal interest rates. In Sweden the increase has been somewhat less and real interest rates have risen. The election result of 4 December in Italy seemed to be expected by the market and the short-term effects were small.

Household indebtedness continues to increase faster than incomes. The debt ratio for households with mortgages continues to rise, by about 5 percentage points in the past 12 months. The rise is driven by a small group of new borrowers and there is an increasing proportion of highly indebted households. There are great differences between banks in terms of how indebted their customers are.

At times the banks take large short-term liquidity risks in Swedish kronor. In addition, the risks vary between different currencies, and are lowest in euros and US dollars but higher in other currencies that are significant for the banks, such as sterling, Danish kronor and Norwegian kronor. The banks continue to face major structural liquidity risks because their funding on average is of short duration; about 3 years. At the same time, lending is at long maturities. The Swedish banks are profitable in relation to their European counterparts, and well-positioned to increase their capital adequacy.

Finansinspektionen presented its analysis of the stability situation. The overall assessment is based on the Financial Stability Report of 1 December. The world economy is recovering, but unevenly. The current situation is relatively calm in the financial markets, but there has been some stress due to the election in the USA and the referendum in the United Kingdom. However, the markets have recovered quickly after these events.

Low global interest rates and the Riksbank's very expansive monetary policy, in combination with good economic growth, are driving up prices and indebtedness, as well as building up risks. At the same time, resilience in the Swedish financial system is satisfactory as a result of banks being generally well-capitalised and above all banks having large buffers and thus great loss-bearing capacity. There are buffers of about SEK 420 billion at present, which is a large amount. If upcoming international regulation is badly formulated, with high minimum capital requirements, this will impact Swedish banks in particular by reducing the buffers and thus resilience.

Swedish banks are dependent on market funding, which, together with long-term lending and short-term funding, creates liquidity risks. The high liquidity requirements imposed on Swedish banks are therefore important and a large amount of liquidity in the major currencies, the dollar and the euro, are particularly important as this gives flexibility in crisis situations.

Housing prices are increasing more slowly since the amortisation requirement was introduced. During the period January-October 2016 prices increased by five per cent compared with 14 per cent in the same period in 2015. In recent months, however, prices have started to rise faster again. At the same time the supply is low, which could press up prices going forward. Consequently, it is difficult to know whether the amortisation requirement has already made its full impact.

Debt growth has slowed somewhat and will gradually fall, unless prices accelerate again. However, debt is continuing to increase far too rapidly and the risks are therefore heightened. The main risk posed by rapidly growing indebtedness is that highly indebted households will cut down heavily on their consumption in a future crisis.

In 2016 Finansinspektionen took several measures against increasing household indebtedness: decisions on increasing the countercyclical buffer, introducing an amortisation requirement and discussions with bank managements and boards of directors.

The National Debt Office added some points and highlighted that the referendum in Italy had greater effect before the election than after, since the markets seem to have positioned themselves for a No outcome. The situation in Italian banks and the political uncertainty that followed the referendum could also, in a negative scenario, have consequences for Swedish banks in the long term.

Swedish banks are well-capitalised, profitable and currently have low credit losses. In a comparison of return on equity, Swedish banks are considerably more profitable than European banks, despite negative interest rates and higher requirements to ensure financial stability. They also have full access to their funding markets and have low funding costs compared with many other European banks.

At the same time the Swedish financial system is sensitive to shocks in international financial markets, partly due to their dependence on market funding in foreign currency. Moreover, there are risks attached to developments in the mortgage market, which are partly driven by the low interest rate environment.

In summary, Swedish banks are well equipped, but domestic risks, such as a fall in housing prices, are estimated to be greater than the external risks.

The Chair expressed thanks for the presentations and proposed moving directly on to a discussion of measures.

§ 2 Discussion of analyses and any measures

Possible measures by the respective authorities, given the discussion above on risks and stability assessment

Finansinspektionen has implemented the amortisation requirement and a debt to income limit is now being analysed. The ceiling should be

designed to slow down continued steep rises rather than limit today's lending. Since all regulation has negative side effects Finansinspektionen is looking at various technical formulations to find the best solution and is prepared to implement a debt to income limit if necessary and when new legislation is in place. Regarding the model for how decisions on a potential debt to income limit and similar macroprudential supervision measures are to be taken, there must be a balance between agency expertise and speed on the one hand and political legitimacy on the other. A model where the Authority prepares a proposal which the Government approves, as applied to the amortisation requirement and central government debt policy would therefore be good.

Finansinspektionen highlighted the need for a co-ordinated policy for household indebtedness. If all the authorities in the Stability Council agree that risks are building up, which they are, it is worth testing the idea of dampening debt growth by means of measures in other areas apart from those for which Finansinspektionen is responsible. This applies for example to tax relief on interest. In addition, it is worth raising the question of monetary policy and the low interest rate in Sweden. Sweden is in an extreme situation with resource utilisation just above normal, at the same time as having negative interest rates. A policy where the inflation target is achieved in the somewhat longer term could mean a somewhat higher policy rate and thus less stimulation for building up debt.

The Riksbank is well aware that the expansionary monetary policy may increase the risks associated with household indebtedness. The Riksbank pointed out the need for various measures in several different policy areas to deal with the structural reasons for increased indebtedness. The entire Swedish housing market is in a state of imbalance, and it has been so for a long time. The Riksbank pointed out the need for measures to improve the balance in the housing market, the need for a holistic approach to tax rules for homeowners and macroprudential supervision measures that limit household indebtedness.

In the first place, it is a matter of offsetting the macroeconomic risk and in the second place, risks in the financial sector. But ultimately, the only thing an individual household can do is borrow more to buy a home. In the long term individual citizens may suffer great harm due to this when interest rates eventually rise.

The risks of short-term funding and long-term lending in the banks needs to be dealt with in some way. It is important that liquidity coverage ratio (LCR) requirements are drawn up in all important

currencies, and that a leverage ratio of five per cent is introduced. Such an increase can also be achieved with risk-sensitive methods. When there is a shift in the interest rate level households will be impacted by the higher interest rates. A debt to income limit could help to manage the risks. The Riksbank considers it to be unfortunate that Finansinspektionen does not have or will not be given the flexibility needed to handle this independently.

The National Debt Office pointed out the increase in construction, which is a good thing and necessary to get the housing market and indebtedness into balance. However, in the short term construction is a factor that drives up the household debt ratio.

The high level of indebtedness is not primarily a failure of regulation but a relative price problem, i.e. it is too cheap to borrow in relation to other factors. The National Debt Office agreed with Finansinspektionen's picture that in the current situation we have an unusual combination of high resource utilisation and a very low interest rate level. In light of this, the National Debt Office welcomes a discussion on how indebtedness affects financial stability and how this should be taken into account in monetary policy. The National Debt Office shared the Riksbank's view that households have few other choices than to continue borrowing for purchasing homes and that this makes them vulnerable when interest rates increase in future.

In addition, tax relief on interest should be reviewed. The time for doing that is now – while interest rates are low. In the current situation, abolishing tax relief on interest is equivalent to about two normal interest rate increases by the Riksbank. Another possible measure that could be considered is to impose requirements on the percentage of fixed-rate mortgages.

Regarding the debt to income limit, it was stated that this does not affect relative prices and thus does not deal with the fundamental problem of it being too cheap to borrow.

The role of the National Debt Office in financial stability primarily concerns ensuring that the banks are resolvable, i.e. that in the event of a crisis they can be dealt with in an orderly manner and without costs to the taxpayers. An important part of that work is formulating well-considered Minimum Requirements for Eligible Liabilities (MREL).

The Chair noted that broad political agreement is necessary to make a decision, but good measures have nevertheless been introduced, such as

the amortisation requirement. However, it is too early to say what the long-term effects of the amortisation requirement will be. Regarding Finansinspektionen's macroprudential supervision mandate, there is broad political consensus and work on legislation is in progress at the Ministry of Finance. The model is that Finansinspektionen will draw up proposed measures, and the Government will support them. This means that the Government will take responsibility for the measures. An extended mandate for macroprudential supervision is expected to be in place in 2018.

The low level of housing construction is a reason for the problems we are experiencing. However, construction is now at a very high level, which is a condition for long-term balance. It is positive that many rental properties are being built, which the Government's package of measures is stimulating.

The housing talks between the Government and parts of the opposition did not achieve any agreement. Regarding the issue of tax relief on interest the Government has not closed the door on talks.

Regulation in Basel and the EU – presentation of proposals

The Chair started by stating that the “banking package” from the European Commission came two weeks ago and work is now in progress on the proposals. The Basel Committee's ongoing work includes measures concerning the banks' capital ratios that may have great significance for Swedish regulation. High capital requirements are important, and they have served Sweden well. In general capital requirements should be adapted to the risks taken by the banks and the risks in the system. A large and concentrated banking sector such as Sweden's means that these requirements must also be adapted to that.

If problems nevertheless arise, it should not be the taxpayers who foot the bill. Consequently, incentives not to take too great risks and opportunities to deal with any problems when they do arise are both needed. That is where the proposals concerning MREL come in. Costs and consequences of different measures aimed at strengthening financial stability must be weighed up.

Swedish interests now need to be safeguarded in negotiations in the EU on the banking package. It is important for the Government to maintain a continual dialogue with the authorities concerning the proposals.

The National Debt Office underlined that as regards regulatory changes, it is important that the Government pushes for flexibility in the EU

rules for Member States to impose requirements that are adapted to national needs, for example as regards MREL. In that regard the banking package seems to be going partly in the wrong direction.

Finansinspektionen mentioned that the proposals by the Basel Committee include restrictions on the use of internal models, which Finansinspektionen supports. However, there are problems as regards the Basel floors, in that they primarily lead to higher capital requirements for banks in northern Europe (including Sweden) that are already relatively well-capitalised, while banks in southern Europe, the USA and for example China are not affected.

The combination of the Basel Agreement and the European Commission's proposals on capital adequacy regulation in the banking package implies a risk that the buffer margin for Swedish banks may be considerably restricted, which would be unfortunate.

The Chair expressed thanks for good comments. Work on the banking package is continuing and before Christmas a factual memorandum on the proposals will be submitted to the Riksdag. The pace of negotiation in the EU is high on these matters. It is important to have a well-functioning comprehensive system for Swedish banks, and this requires analyses and collaboration between the authorities.

Updating the work on resolution plans

The National Debt Office presented information on its work to launch the new resolution framework that has been in force since February 2016.

Resolution work is complex, and the banking package means regulations are changing even before they have started to be fully applied. Few, if any, EU countries have managed to keep to the timetable assumed in the EU regulations.

The National Debt Office is completing work on the model to lay down MREL and will take a decision on the model in the first quarter of 2017. The issue of subordination requirements is central in this context to ensure the banks' resolvability. In light of this, the National Debt Office welcomed the proposal in the banking package on harmonisation of priority rights and at the same time emphasised the importance of this being rapidly incorporated into Swedish law.

As regards resolution plans for individual banks, the National Debt Office is in the final stages of establishing the first plans for the major

banks. Plans for other institutions will be established after the turn of the year.

Lessons learned from scenario exercises

The Stability Council Secretariat reported the results of the first scenario exercise. On 19 October 2016 a scenario exercise was held with participation by the authorities in the Council. The exercise was devised by the Council Secretariat together with the authorities.

The purpose of the exercise was to practice the authorities' coordination and exchange of information for crisis management of financial institutions and to identify any lack of clarity in the application of the overall bank recovery and resolution framework introduced in Sweden earlier this year. The purpose of the exercise was also to gain a better understanding of the authorities' roles in the recovery and resolution process as well as increase knowledge of how, and on what conditions, assessments are made and decisions made in recovery and resolution.

After completing the exercise the authorities identified a number of lessons learned and outstanding questions in recovery and resolution, which will be dealt with in joint projects.

The exercise was the first in a series of three. The remaining exercises will be held in 2017.

The Chair emphasised that these exercises are important in preparing to deal with a crisis. Much has happened with new regulations and the preparatory group and the Secretariat are tasked with drawing up a plan for dealing with the lessons learned.

§ 3 Evaluation of the work of the Committee

The Ministry of Finance presented the evaluation. On the instructions of the preparatory group, officials at the Ministry of Finance have interviewed participants from the Stability Council, the preparatory group and the Stability Council Secretariat. Three areas were in focus; achievement of objectives, meetings and the role of the Secretariat. Setting up the Committee formalised collaboration on financial stability, which the authorities consider has been positive.

Regarding the minutes, they should provide a summary but be detailed enough to reflect a fair picture of the discussion. Regarding the organisation of Stability Council meetings, no changes are proposed, but the importance of long-term planning of the Council meetings was

underlined. The mandate of the Stability Council Secretariat was clarified with the task of coordinating crisis planning and preparing scenario exercises.

The Riksbank considered that the evaluation has been good in terms of the present structure. To strengthen the Council, the major evaluation of the Committee in 2019 is important. This may include a proposal to study how other countries organise equivalent activities.

The National Debt Office agreed that the evaluation was valuable. One question to be considered for the future is the role of the Secretariat and its possibilities to plan the work of the Committee.

Finansinspektionen shared the view that it is a good analysis. The Committee has existed for a fairly short time, but it is positive that it is developing without making radical decisions.

§ 4 International recommendations and collaboration

Warnings and recommendations

The Chair expressed thanks for contributions from the authorities to the IMF's evaluations (FSAP and Article IV). Sweden has been praised for the work. The IMF has given valuable comments and Sweden by and large comes off well in the evaluation. There are several proposals to work on further and the intention is to regularly follow up how the authorities work on the proposals. The Stability Council is also in focus in the evaluation and there it is important to understand that the Swedish solution is created on the basis of the Swedish administrative model with independent authorities.

Apart from the IMF, the European Systemic Risk Board (ESRB) has issued a warning about vulnerabilities associated with the housing sector. As already discussed, the authorities by and large agree with that analysis.

Finansinspektionen noted that the IMF considers that Finansinspektionen's powers should be strengthened and its resources increased.

Finansinspektionen welcomes the fact that the ESRB points out that Sweden needs to do more to manage risks linked to household indebtedness. In light of this, it is remarkable that the European Commission wants to reduce the possibilities of taking such measures as part of the capital adequacy regulations.

The Riksbank noted that the IMF has pointed out in three FSAP evaluations in a row that Finansinspektionen needs more resources. It is important that Finansinspektionen receives sufficient resources bearing in mind its extensive remit.

Nordea's conversion to a branch structure

Finansinspektionen briefly presented the process of Nordea's conversion of subsidiaries into branches. The authorities discussed the cross-border aspects of the conversion to branches.

The Chair stated that the decision to convert is taken by the bank and has been approved by Finansinspektionen. The process varies somewhat in the Nordic countries.

§ 5 Future work to strengthen financial stability

Ahead of the next meeting of the Stability Council on 12 June 2017, the Council members will continue to discuss several of the matters discussed at today's meeting, including household indebtedness and future capital requirements for the banks. The Committee will work together on scenario and crisis exercises.

§ 6 MoU

The authorities in the Stability Council signed a MoU on cooperation relating to financial stability and crisis management.

The MoU replaces the MoU between the parties in May 2009. The MoU describes the authorities' remits, tasks and roles in promoting financial stability and in crisis management. The purpose of the MoU is to make a declaration of intent on cooperation, information sharing and knowledge exchange to achieve appropriate crisis management and promote financial stability in Sweden.

§ 7 Other questions

The National Debt Office pointed out that the Swedish policy that includes high capital requirements of the banks has served Sweden well. In the light of the ongoing regulatory reforms it should be considered whether proposed measures are sufficient to secure stability or if further measures are needed. In that context it is important to make a combined analysis of economic benefits of a stable financial sector as well as any costs of reduced lending on the basis of existing and proposed regulations. There are circumstances that indicate that the net effect on the national economy continues to be positive.