S P E E C H

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Amortisation requirement and risk weights – two current issues for macroprudential policy

Hello and thank you for inviting me here to talk about our view of some current issues in the area of macroprudential policy.

The first concerns the way we view the risks linked to household debt and the need for amortisation requirements. I will also describe our view of the formulation of capital requirements for Swedish banks and what measures we see ahead in this area in the near term. But to put things in context here, I shall start off by describing Finansinspektionen's remit.

Finansinspektionen is responsible for macroprudential policy

Finansinspektionen has had the assignment of contributing to the stability of the financial system and promoting sound consumer protection since 1995.[1] Financial stability means that the financial system can sustain its fundamental functions –processing payments, supplying credit and managing risk – and furthermore, that it also has good resilience to shocks. I intend to return to the discussion on Finansinspektionen's ability to introduce an amortisation requirement a little later. But let me emphasise now that the discussion does not have any bearing on the assignment we have had for 20 years. All along we have had the powers of authority required to take appropriate action to promote both financial stability and sound consumer protection.

The experiences from the financial crisis in 2008 showed that it is not enough merely to act to promote financial stability. Finansinspektionen was therefore given an extended assignment in 2014, which entails counteracting financial imbalances to stabilise the credit market.[2] The new element here is that we are responsible for macroprudential policy, which means that we are to intervene if financial developments could lead to problems in the economy, even if neither

[1] See section 2 of the Ordinance (1994:1538) on amending Finansinspektionen's Instructions Ordinance (1992:102). This amendment entered into force on 01/01/1995.
[2] See section 1 of the Ordinance (2013:1111) on amending Finansinspektionen's Instructions Ordinance (2009:93). This amendment entered into force on 01/01/2014.

the stability of the financial system nor consumer protection are threatened. To carry out this extended assignment, Finansinspektionen needs to have the scope to take measures against financial imbalances. However, Finansinspektionen was not given any new powers of authority when the assignment was extended. This is the reason for the legal question marks regarding whether we have the right to introduce an amortisation requirement for this particular purpose.[3] If we are to regulate, there should be no uncertainty. We therefore chose not to proceed with the proposal last spring. Instead, we turned to the government and asked them to give us the powers of authority required to proceed with the introduction of the amortisation requirement.

It is good that we can now introduce the amortisation requirement

The Swedish household sector debt ratio – debt in relation to disposable income – is currently almost 175 per cent. This is high from both an international and historical perspective. Moreover, growth in lending to households has been increasing since the middle of 2012, and currently amounts to just over 7 per cent a year, which is much more than the increase in disposable incomes. At the same time, house prices have continued to rise from already high levels, which has meant that an increasing number of households are taking on mortgages with loan-to-value ratios of more than 50 per cent. Furthermore, these households often wait before amortising their loans. This is worrying, as international experiences suggest that households with loan-to-value ratios of 40-50 per cent or more react particularly strongly to macroeconomic shocks. Though they do not cease paying their mortgages if their income declines, they may be forced to reduce other consumption. In this way, their behaviour could amplify an economic downturn.

Our assessment is that the risks linked to the high household indebtedness are not alarming at present. But the trend is worrying. In a few years' time, rising house prices and low interest rates may push up credit growth and the percentage of households with relatively high debts even further, aggravating the situation. To reduce the risk of this happening, we want to introduce an amortisation requirement in Sweden. Its purpose is to equip households with a better resilience to shocks by ensuring that the households with the highest loan-to-value ratios reduce them. This dampens the macroeconomic risks. The longer this takes to implement, the greater the risk that much tougher measures will be needed than the introduction of an amortisation requirement. As you probably know, our proposal has the support of both the Riksbank and the Swedish National Debt Office.[4] It is therefore positive that there is now political unity on giving us the scope to introduce this requirement.

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[3] If the purpose of the requirement had instead been to protect consumers or to promote the stability of the financial system, we could have introduced it on the basis of the powers of authority we already have.

[4] See Ingves, S, H. Lindblad and M. Noréus, "Tydligt amorteringskrav bör införas snarast möjligt" (a clear amortisation requirement should be introduced as soon as possible), DN newspaper 17 August 2015.

Finansinspektionen sees risks in introducing a binding leverage ratio requirement

Let me now move on to another topical question in the field of macroprudential policy – the banks' capital levels. To begin with, let me remind you why capital requirements for the banks were introduced. The banking system contains both implicit and explicit guarantees, as large banks have been considered too important to the economy for the state to allow them to fail in the past. These guarantees have resulted in the disabling of an important market mechanism, in that the cost of loan financing does not rise to its full extent if a bank opts for a high debt ratio. Thus, these guarantees, together with the fact that interest expenses are tax-deductible, mean that it is usually profitable for banks to fund their business with a very large proportion of borrowing.

But high debt ratios mean they are sensitive to disturbances and losses. In such situations there is a risk that banks might not be able to fulfil their role in the financial system, which could have significant adverse consequences for the economy. At worst, the banks might need to be rescued by the state, which can be costly for tax-payers and even lead to problems in public finances. It is therefore important for society in general that the banks have sufficient capital to meet their commitments and can continue to operate, even if they were to suffer losses. This is why Finansinspektionen requires that the banks have a level of capital that is sufficient to cover losses that could arise in the event of severe financial stress. And because problems in one bank can spread to others, banks must also maintain capital to reduce such systemic risks.

The current capital adequacy regulations are substantially risk-based. This means that the higher the risk an asset has, the more capital a bank must hold against it. The Basel Committee is currently working on supplementing the risk-based regulatory framework with a leverage ratio requirement, which is a non-risk sensitive requirement. The question is how high this requirement should be set. Finansinspektionen believes there are risks in setting it too high, so that it becomes a binding capital restriction, that is one which determines how much capital banks must retain. Risks arise as a result of the incentives that such a requirement creates for the banks, which in the long term could have significant effects on the entire financial sector.

Under a binding leverage ratio requirement, a bank has to hold the same amount of capital regardless of the credit risk. For instance, a bank must hold as much capital to lend 30 million kronor to the Swedish state as to lend the same amount to fund high-risk speculative projects. High-risk lending usually results in higher returns as compensation for the higher risk. A binding leverage ratio requirement gives a bank the incentive to shift its business towards higher-risk lending and thus generate a higher return on equity. This increases the risk of large credit losses and makes the bank and the entire banking system more risky. Business that involves low credit risk and low returns, such as mortgage loans and lending to highly creditworthy corporations, may also be securitised, sold in some other way or discontinued entirely. This results in this type of business being removed from banks' balance sheets and often ending up outside the regulated banking sector, in what is called the shadow banking sector. This results in a reduction in the size of the bank and the entire banking system, measured in terms of assets.

The introduction of a binding leverage ratio requirement could therefore result in Sweden having a smaller but higher-risk banking system and in the supply of credit to the real economy taking place to a greater extent via financial markets. Although more lending via financial markets means more funding channels, which could increase efficiency, it could also pose risks. One of these risks is that the credit supply could become less stable than it currently is. Experience from the US suggests that a more market-based system could be particularly sensitive during times of crisis[5].

So what is the debate on the capital requirements for banks really about? I interpret it as all of the authorities being in agreement that a more stable financial system would be good. But not being in agreement on how to achieve this. The Riksbank wants to raise the capital levels in the banks, partly by setting the leverage ratio requirement at such a high level that it becomes the binding requirement and so would determine how much capital the banks must hold.[6] They say that more capital in the banks increases their resilience to losses, which promotes financial stability. However, Finansinspektionen assesses that, on the contrary, a binding leverage ratio requirement could lead to a deterioration in financial stability because of the effects I have previously described and that it is therefore the wrong direction to take. We consider that a leverage ratio requirement could instead fulfil an important function as a back-stop that sets a floor as to how low the capital requirement can fall in relation to the banks' gross assets. If capital requirements are to be raised for Swedish banks, we think this should instead take place via risk-based regulation.

However, I would like to make it clear that our stance on risk-based capital requirements is based on an overall assessment of the advantages and disadvantages. If they are well-designed, risk-sensitive capital requirements give a more accurate picture of a bank's capital needs. Moreover, they create strong incentives for healthy risk taking and good control of the measuring, reporting and management of risks in the balance sheet. The disadvantage is that models can be wrong and that the banks will also have strong incentives to utilise the models to push risk weights down further than is justified by the actual level of risk. Our stance assumes that we will be able to limit these disadvantages by means of regulation and supervision. Let me therefore discuss these regulations and how we can ensure the capital strength of the banks in greater detail.

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[5] Reinhart and Rogoff (2008) say that the US development towards a more market-based system may well have increased the financial system's resilience to certain types of shock, but that the system may also have become more vulnerable to other types of shock.
[6] See Financial Stability Report 2014:2, Sveriges Riksbank.

The risk weights on the banks' corporate exposures have fallen more than is justified by the actual risk level

The capital requirements for Swedish banks are already currently significantly higher than EU minimum levels. The Swedish banks are also well capitalised compared with banks elsewhere in Europe, both from a risk-weighted and a non-risk-weighted perspective. At the same time, the Swedish banks' average risk weights have gradually decreased since the introduction of Basel 2 in 2007. This is both because the banks have gradually increased the use of internal models, which entail lower risk weights for low-risk assets in relation to the standardised approaches, and because the banks have shifted their operations towards lending with lower risk.

Finansinspektionen believes that the increased use of internal models has largely provided a more accurate view of risk in the Swedish banks. At the same time, the banks have strong incentives to reduce the risk weights, to bring down the actual capital base, which ultimately increases the return on equity. The use of internal models gives the banks the opportunity to reduce their risk weights.

If we study corporate exposures, the average risk weights have declined over time. This reflects several positive developments, such as the risk-based capital adequacy regulations having given the banks incentives to lend more to counterparties with good credit ratings and good collateral and less to customers with higher risk and poorer collateral. The banks have also become better at requiring and registering collateral and guarantees for the loans granted.

But we assess that the decline in risk weights is also due to factors that are not linked to the change in the actual risk level. The period since the models began to be introduced has been characterised by very small losses in large parts of the banks' loan portfolios. When the banks estimate credit risk using their internal models, they use their actual loan losses as a base. The more years with small loan losses that are included in these estimates, the lower the risk weights will be. Here there is a risk that the internal models are guided too much by loan losses from relatively beneficial years.

We can also note in our supervision of the banks that they to some extent practise risk-weight minimisation, which means that they over exploit regulatory opportunities to bring down risk weights. One example of this is when a bank has in practice granted a firm funding for a long period to come, but the loan agreement is designed with a short maturity, or gives the bank the right to terminate the loan at short notice. A short maturity in the contract means that the loan has a lower risk weight. We assess that in many cases it is doubtful whether the loan can actually be terminated at such short notice. And even if the banks were actually prepared to do this in a financial crisis, such behaviour is not desirable from a macroeconomic point of view. This is also an example of a factor that has led to risk weights decreasing more than is justified by the actual level of risk.

In this context, one can note that market confidence in the banks’ models is already low and has hardly been improved by many banks launching major projects in recent years that have the more or less explicit aim of pushing risk weights down as far as possible. This is extremely short-sighted behaviour that gives further ammunition to those critical of the banks’ models and of risk-sensitive capital requirements in general.

But is it possible to be a strong advocate of risk-based regulations, based on internal models, and at the same time critical of how the models are currently applied? Yes, it is. As I mentioned earlier, Finansinspektionen considers that efficient risk-weighted capital adequacy regulations are preferable to a binding leverage ratio requirement. But this assumes that we can rectify the weaknesses in the internal models.

A large part of the tightening of the regulatory framework with regard to internal models that we wish to see will need to be achieved through international agreements and European legislation. Finansinspektionen is therefore an active advocate of the initiatives taken by the EBA and the Basel Committee to improve the regulatory framework with regard to internal models. But it will take a few years before any such international initiatives have been implemented.

But there is a lot that can be done now in Sweden. Finansinspektionen is currently investigating various possibilities to better manage model risks and to tackle specific weaknesses in the construction of the internal models. We will require the banks to amend their models. Measures within the scope of Pillar 2 may also be introduced, that is, further capital surcharges in addition to those indicated by the models. The results of our measures will gradually become visible and next year we expect will lead to a marked increase in the capital requirements for corporate exposures in particular.

Conclusion

Let me summarise. Household debt currently offers no immediate threat to financial stability, but the trend is worrying. It is thus positive that there is now political unity on giving us the scope to introduce the amortisation requirement.

The risk-based capital adequacy regulations have many good qualities, and the Swedish banks are well-capitalised. However, the risk weights on the banks’ corporate exposures in particular have declined more than is justified by the actual risk level. We intend to remedy this, both by requiring changes in how the banks apply their internal models and possibly through further capital requirements within Pillar 2. The effects of this will be noticeable.

Thank you!