

DECISION MEMORANDUM



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## Regulations regarding the countercyclical buffer rate

### Summary

Finansinspektionen issues new regulations regarding the countercyclical buffer rate. Finansinspektionen shall, in accordance with the Capital Buffers Act (2014:966), set countercyclical buffer guides and countercyclical buffer rates. The countercyclical buffer rate shall be applied by credit institutions, investment firms, Svenska skeppshypotekskassan, fund management companies with discretionary portfolio management and alternative investment fund (AIF) managers licensed to conduct discretionary portfolio management when calculating the institution-specific countercyclical capital buffer. Setting the buffer rate is a matter of setting standards and Finansinspektionen must therefore issue this rate in the form of regulations.

The countercyclical capital buffer for Sweden is to be activated and set at 1 per cent given the present economic conditions. This position is based on a qualitative assessment that takes account of quantitative factors, including the buffer guide. The countercyclical buffer guide for Sweden is to be set at 1.25 per cent given the present economic conditions.

Credit growth does not currently appear to be excessive in Sweden. The growth rate for corporate lending is lower than nominal GDP growth. For household credits, the growth rate is slightly higher than nominal GDP growth, but has slowed down from previous levels and is growing more or less in line with disposable income. At the same time, household indebtedness remains high in both a historical and international perspective. The credit expansion that has taken place for a number of years can pose risks to the financial system and the real economy. Finansinspektionen finds that there are grounds for activating the countercyclical capital buffer in Sweden, given the risks overall and present economic conditions.

It is important, when setting the buffer rate, to also take account of other measures that Finansinspektionen will take to manage systemic risks. Finansinspektionen finds that increased risk weights for mortgages, combined with an activation of the countercyclical capital buffer, is an appropriate and effective approach for raising the resilience of the banks without simultaneously increasing too much the capital requirements for corporate lending.

Finansinspektionen's overall opinion, taking account of the information provided by the credit gap and other quantitative indicators, Finansinspektionen's assessment regarding the development of and sustainability in credit growth, and the imminent increase in the risk weight floor, Finansinspektionen's overall opinion is that the countercyclical buffer rate in Sweden based on present economic conditions shall be 1 per cent.

The countercyclical buffer rate stipulated in the regulations shall be applied as of 13 September 2015.

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## 1 Starting points

The Capital Requirements Directive<sup>1</sup> contains provisions regarding setting the countercyclical buffer rate (see, inter alia, Article 136). These provisions are mainly implemented in Swedish law through Chapter 7, sections 1–3 of the Capital Buffers Act (2014:966) – the buffer act. According to Chapter 7, section 1, Finansinspektionen shall, for each quarter, set a countercyclical buffer guide and a countercyclical buffer rate. The countercyclical buffer guide shall be used as a reference in setting the countercyclical buffer rate, which shall provide the basis for calculating the size of the institution-specific countercyclical capital buffer according to Chapter 6 of the same act.

The countercyclical buffer rate set by Finansinspektionen pursuant to Chapter 7, section 1 of the aforementioned act shall be applied by all institutions concerned. Finansinspektionen's decision to set these rates is thus a matter of setting standards and shall therefore be issued in the form of regulations.

The institutions covered by the buffer act are credit institutions, investment firms, Svenska skeppshypotekskassan, fund management companies with discretionary portfolio management and alternative investment fund (AIF) managers licensed to conduct discretionary portfolio management. In this memorandum, “firm” is used as a collective term for these institutions.

### 1.1 Objective of the regulation

The countercyclical capital buffer is a time-varying capital requirement with the primary purpose of strengthening the resilience of firms. The reason for the capital requirement varying over time is to effectively ensure that the banking system as a whole has sufficient capital to sustain the flow of credit to the real economy at times when shocks to the financial system could cause a credit crunch. The purpose of the regulations is to decide on and communicate, in a lawful, clear and structured manner, Finansinspektionen's regular decisions regarding the countercyclical buffer rate. All of this is part of implementing the Capital Requirements Directive in Swedish law.

### 1.2 Current and forthcoming regulations

There are no previous regulations corresponding to those present. On 25 June 2014, Swedish Parliament decided on new statutory provisions regarding capital adequacy rules, including the buffer act. The statutory provisions mainly entered into force on 2 August 2014.

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<sup>1</sup> Directive 2013/36/EU of the European Parliament and of the Council of 26 June 2013 on access to the activity of credit institutions and the prudential supervision of credit institutions and investment firms, amending Directive 2002/87/EC and repealing Directives 2006/48/EC and 2006/49/EC.

### **1.3 Alternative to regulation**

Sweden is obliged to implement the rules of the Capital Requirements Directive regarding e.g. countercyclical capital buffers. This involves, with due consideration for the Swedish judicial system, an obligation for Finansinspektionen to issue regulations regarding countercyclical buffer rates. There is thus no alternative to regulation.

### **1.4 Legal basis**

Finansinspektionen shall, according to Chapter 7, section 1 of the buffer act, for each quarter set a countercyclical buffer rate and, according to the Special Supervision and Capital Buffers Ordinance (2014:993), Finansinspektionen is authorised to issue implementing regulations by reason of this provision.

### **1.5 Exemptions for small and medium sized enterprises**

According to Chapter 6, section 3 of the buffer act, which implements Article 130(2) and 130(3) of the Capital Requirements Directive, Finansinspektionen is given the possibility of exempting small and medium sized enterprises from maintaining an institution-specific countercyclical capital buffer. It is set out in these provisions that investment firms, management companies and AIF managers categorised as small and medium-sized enterprises may be exempted from requirements regarding a countercyclical capital buffer if they do not pose a threat to financial stability in Sweden. If such an exemption is decided, justification must be provided as to why this is not considered to pose a threat to financial stability in Sweden. Small and medium sized enterprises shall be defined based on Commission Recommendation 2003/361/EC of 6 May 2003 concerning the definition of micro, small and medium-sized enterprises.

On 8 July 2014, Finansinspektionen published on its website regulations (FFFS 2014:12) regarding prudential requirements and capital buffers (the regulations regarding prudential requirements and capital buffers) by reason of the Capital Requirements Regulation having started to apply and the implementation of the Capital Requirements Directive in Swedish law. According to Chapter 9, section 1 of the regulations regarding prudential requirements and capital buffers, small and medium sized investment firms, fund management companies with discretionary portfolio management and AIF managers with discretionary portfolio management are exempted from the requirement to maintain an institution-specific countercyclical capital buffer.

The countercyclical capital buffer is activated when Finansinspektionen finds that the growth rate in lending is excessive, which could in turn give rise to systemic risks. The small and medium sized enterprises exempted from the requirement of having a countercyclical capital buffer are not deemed to give rise to excessive credit growth, and therefore do not contribute to the build-up of systemic risk. In light of this, Finansinspektionen finds that financial stability in Sweden is not threatened by such firms being exempted from the

requirement of having a countercyclical capital buffer. The same regulations stipulate that small and medium sized enterprises shall be defined as firms employing fewer than 250 people and with an annual balance sheet total of no more than EUR 43 million in accordance with the Commission recommendation. Applying this definition implies that all credit institutions, seven investment firms and three management companies with discretionary portfolio management will be covered by the requirement to hold an institution-specific countercyclical capital buffer.

## 1.6 Preparation

During the course of its work with the regulations, Finansinspektionen has held discussions regarding the appropriate level for the countercyclical buffer in the Financial Stability Council. The relevant authorities that are members of the Council have participated in the discussion and expressed their views and arguments regarding the buffer rate. Members of the Council are the Ministry of Finance, the Riksbank, the Swedish National Debt Office and Finansinspektionen.

In addition, Finansinspektionen has previously described a number of positions regarding the countercyclical capital buffer in the memorandum regarding capital requirements for Swedish banks (the capital requirements memorandum) published on 8 May 2014.<sup>2</sup> These positions pertain to the choice of method for setting the countercyclical buffer rate in Sweden, and considerations regarding the need to activate the countercyclical capital buffer in Sweden given the currently prevailing economic and financial conditions. The feedback regarding these questions, received within the framework of submitting the capital requirements memorandum for consultation, are presented and answered in this decision memorandum.

On 12 June 2014, Finansinspektionen submitted a proposal for regulations regarding the countercyclical buffer rate together with a consultation memorandum. The purpose of the proposed regulations was to decide on and communicate, in a lawful, clear and structured manner, Finansinspektionen's regular decisions regarding the countercyclical buffer rate. Focus was on Finansinspektionen's considerations and reasons for setting the buffer rate itself, i.e. the level (as a percentage of the total risk-weighted exposure amount) of the countercyclical capital buffer.

Written feedback on the proposal has been received from The Swedish Bankers' Association, the Association of Swedish Finance Houses, the Swedish Savings Banks Association, the Swedish Investment Fund Association, the Riksbank, the Swedish National Debt Office, the Confederation of Swedish Enterprise, the Swedish Better Regulation Council,

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<sup>2</sup> FI (2014), *Capital requirements for Swedish banks*. Published on fi.se on 8 May 2014, FI ref. 14-6258.

the Swedish Competition Authority and the Financial Sector Union of Sweden. Some other consulted bodies, such as the Swedish National Board of Housing, Building and Planning, Kommuninvest, the Swedish Accounting Standards Board and FAR (the Professional Institute for Authorised Public Accountants) approved the consultation proposal without providing any feedback, or refrained from expressing an opinion. After the consultation, Finansinspektionen has prepared the proposed regulations and in that work taken account of the feedback from the consulted bodies. The main points of feedback are provided and addressed under each position.

## 2 Reasoning and considerations

Finansinspektionen's positions and the considerations made pertaining to the regulations regarding the countercyclical buffer rate are described below.

The section describes Finansinspektionen's position relating to the size of the countercyclical capital buffer rate in Sweden. The section also includes a description of the method for setting the countercyclical buffer rate in Sweden and the considerations made pertaining to the need to activate the countercyclical capital buffer in Sweden, and the size of the buffer rate given the economic and financial conditions currently prevailing.

### 2.1 Background

The countercyclical capital buffer is part of the Basel 3 agreement.<sup>3</sup> The background to the introduction of the buffer is that financial markets tend to act in a procyclical manner. In other words, they amplify cyclical fluctuations in the real economy. In periods of high economic growth, banks and investors tend to take greater risks, for instance by increasing lending to the private sector. This can lead to excessive credit growth. When such a period is followed by a downturn in the financial cycle, when the stress level in the financial system is often high and access to liquidity scarce, the banks tend to tighten credit supply by cutting back on lending to the real economy. This behaviour serves to amplify cyclical fluctuations.

In order to ensure that the banking sector has sufficient capital to supply the economy with credit, even in periods of financial stress, it might be effective to have capital requirements that vary over time. The countercyclical capital buffer is such a capital requirement, which aims to manage cyclical systemic risks. The buffer is activated in economic boom periods, when credit growth is high. In downturns, when unexpected losses can quickly arise and access to capital is limited, the buffer is reduced or released. The buffer built up during the period of high credit growth and sound profitability can then be drawn down when economic and financial circumstances are less favourable. This is

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<sup>3</sup> Basel 3: *A global regulatory framework for more resilient banks and banking systems*, December 2010, and updated in June 2011, [www.bis.org](http://www.bis.org).

to serve as support for credit supply because it reduces the risk of credit firms being forced to tighten lending due to a capital shortage at a time when the financial system is under strain. However, it should be emphasised that the countercyclical capital buffer is not intended to be an instrument for managing the business cycle or asset prices. These can rather be managed, as needed, through fiscal and monetary policy and other public measures.<sup>4</sup>

The main purpose of the countercyclical capital buffer is consequently to strengthen the resilience of firms and ensure that the banking system as a whole has sufficient capital to sustain the flow of credit to households and corporations, at times when shocks to the financial system could cause a credit crunch. A potential positive side effect is that the buffer could help curb lending in periods of excessive credit growth, although that is not the main purpose of the buffer.

## 2.2 Legal basis

### 2.2.1 *The Capital Requirements Directive and implementation in Swedish law*

As mentioned above, the provisions of the Capital Requirement Directive regarding countercyclical capital buffers are implemented in Swedish law through Chapters 6 and 7 of the buffer act.

The countercyclical capital buffer is to reflect the cyclical systemic risk associated with excessive credit growth in the financial system, and is to be met by firms at individual and consolidated level, see section 7.2.3 of the preparatory work for the buffer act, prop. 2013/14:228.

Chapter 6, section 1 of the buffer act sets out that the countercyclical capital buffer shall be calculated by multiplying the total risk-weighted exposure amount of a firm by a weighted average of the so-called countercyclical buffer rates that apply for countries in which the firm has its relevant credit exposures. The countercyclical capital buffer shall, according to the same provision, be covered by common equity Tier 1 capital. Finansinspektionen is authorised in Chapter 10, section 1, point 6 to prescribe what is meant by 'relevant credit exposures', see Chapter 9, section 2 of the regulations regarding prudential requirements and capital buffers.

Finansinspektionen shall, according to Chapter 7, sections 1 and 2 of the aforementioned act establish on a quarterly basis a countercyclical *buffer guide* and a countercyclical *buffer rate* in the manner and based on the factors set out in Articles 136(2) and 136(3) of the Capital Requirements Directive. When establishing such rates, Finansinspektionen shall also take into consideration guidelines from the European Systemic Risk Board (ESRB). It is set out in the preparatory work for the buffer act (see section 7.2.3 of prop. 2013/14:228)

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<sup>4</sup> BCBS (2010), *Guidance for national authorities operating the countercyclical capital buffer*.



that it must be considered natural that in the future Finansinspektionen holds discussions with the relevant authorities in order to make well-founded decisions on the countercyclical buffer rate. However, the Government does not see a need to set out in law a requirement for consultation to precede decisions in this matter.

Thus the buffer guide shall serve as a reference when Finansinspektionen sets an appropriate countercyclical buffer rate for Sweden. The buffer guide shall be calculated on the basis of the so-called credit gap. This gives the deviation of the ratio of credit-to-GDP from its long-term trend.

The buffer guide shall also serve as a basis for Finansinspektionen's assessment of the size of the countercyclical buffer rate in Sweden. However, it is set out in the preparatory work (section 7.2.3 of prop. 2013/14:228) that decisions on the countercyclical buffer rate should be based on both quantitative and qualitative assessments of the sustainability of the credit development and the level of systemic risks. Finansinspektionen shall also take into account other relevant variables that could signal the build-up or slowdown of cyclical systemic risk, and perform its own qualitative assessments. The intention is not a mechanical setting of the countercyclical buffer rate.

According to Chapter 7, section 3 of the buffer act, the countercyclical buffer rate shall be between 0 and 2.5 per cent of the total risk-weighted exposure amount and be expressed in intervals of 0.25 per cent. Finansinspektionen may, according to the same provision, set a countercyclical buffer rate that is higher than 2.5 per cent, if it is justified based on the factors specified in Articles 136(2) and 136(3) of the Capital Requirements Directive. This higher buffer rate will, however, not automatically apply for the branches of foreign firms in Sweden, but must first have been approved by the domestic authorities, as set out in Article 137 of the Capital Requirements Directive.

A decision to activate or increase a countercyclical buffer rate must contain information about when the buffer rate starts to apply. Decisions involving an increase to the buffer rate must, as a general rule, start to apply twelve months after the decision was announced. However, the decision may start to apply earlier if there are special grounds. Decisions to reduce the buffer rate shall start to apply immediately, see Chapter 7, section 6. Decisions about the countercyclical capital buffer rate must also be published and motivated, see Chapter 7, section 8 of the same act.

Hence, unless it is a case of reducing the rate, it is the point in time at which the decision is published that normally determines when the rate shall start to apply. 'Publish' in this context must be understood as the date on which the decided regulations were issued in print. Beforehand, Finansinspektionen will have published the regulations and decision memorandum forming the basis thereof on its website.

According to Chapter 10, sections 6–9 of the buffer act, it is proposed that the Government or the authority designated by the Government be authorised to issue regulations on which credit exposures are to be taken into consideration when calculating the countercyclical capital buffer, the calculation of the weighted average of the countercyclical buffer rates, and the obligation of firms to state the geographic location of their credit exposures. The authorisation also includes issuing regulations about the criteria regarding which small and medium-sized investment firms, management companies and AIF managers may be exempted from the requirement to meet a countercyclical capital buffer (see section 1.5). Finansinspektionen has, by reason of these authorisations and the authorisations in the Special Supervision and Capital Buffers Ordinance (2014:993), published the regulations regarding prudential requirements and capital buffers.

EBA has, supported by the authorisation in Article 140 of the Capital Requirements Directive, prepared proposals for technical supervision standards that specify the method for identifying the geographical location of the relevant credit exposures.<sup>5</sup>

### 2.2.2 ESRB's guidelines

On 18 June 2014, ESRB decided on a recommendation regarding guidelines for setting the countercyclical buffer rate.<sup>6</sup> This was published on ESRB's website on 30 June 2014. In Finansinspektionen's opinion, the positions set out in this memorandum coincide with the guidelines for setting countercyclical buffer rates published by ESRB.

## 2.3 Method for setting the countercyclical capital buffer rate

As described in section 2.2, according to the legal basis, Finansinspektionen must calculate and publish a buffer guide and a buffer rate quarterly. The buffer guide is to provide the basis for determining the size of the countercyclical buffer rate, but the decision should not only be based on the buffer guide. Other relevant variables too that could signal a build-up of or slowdown in cyclical systemic risks, and the ESRB's guidelines and recommendations, are to be taken into account.

**Finansinspektionen's position:** Finansinspektionen will set the countercyclical buffer rate for Sweden on the basis of a qualitative assessment that takes quantitative factors into consideration. *The buffer guide* will be an important but not determining factor in the overall assessment. The qualitative assessment will also take account of other quantitative variables that may

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<sup>5</sup> EBA (2013), *Final draft regulatory technical standards on the method for the identification of the geographical location of the relevant credit exposures under Article 140(7) of the capital requirements directive (CRD)*.

<sup>6</sup> ESRB (2014), *ESRB Recommendation on guidance for setting countercyclical buffer rates*, ESRB/2014/1.

change over time. The Basel Committee's standardised approach will be used to calculate the countercyclical buffer guide.

**Consultation memorandum:** Contained the same proposals.

**Consulted bodies:** *The Riksbank* shares Finansinspektionen's view that the buffer rate should be set based on a qualitative assessment and that quantitative indicators should not be used mechanistically. This is because individual quantitative indicators, including the credit gap, can be misleading. The Riksbank therefore finds that it is important, when setting the countercyclical buffer rate, to take into consideration, besides the buffer guide, also other quantitative indicators and make an overall systemic risk assessment. Furthermore, the Riksbank shares Finansinspektionen's opinion that the buffer guide should be set based on the credit gap in accordance with the standardised approach of the Basel Committee.

**Finansinspektionen's grounds:** The study that forms the basis of ESRB's guidelines and which was published in connection therewith in June 2014 contains results and conclusions from a comprehensive analysis performed by ESRB's expert group for guidance in setting countercyclical buffer rates.<sup>7</sup> The analysis shows that the credit gap, calculated using the standardised approach of the Basel Committee, is an indicator with good signalling qualities for the build-up of systemic risk, which could cause the buffer to be activated or increased.

At the same time, it is ascertained that the credit gap indicator does not always work well. Therefore, other relevant indicators should be taken into consideration when assessing the build-up of systemic risks. ESRB's guidelines contain recommendations on six different categories of indicators that are to serve as a complement to the credit gap. These categories include various measures of credit developments, measures that indicate any potential overvaluation of property prices, measures of external imbalances, measures that show the strength of bank balance sheets, measures of private sector debt burden, and measures that could indicate potential mispricing of risk. ESRB recommends that at least one variable in each category be continually monitored and published in connection with the publishing of the buffer rate. In addition, the credit gap and the supplementary variables used in the analysis should be continually evaluated.

In summary, ESRB finds that the qualitative assessment, combined with the credit gap and other relevant indicators, should guide the national authority in setting the countercyclical buffer rate. In accordance with ESRB's guidelines, Finansinspektionen will set the buffer rate on the basis of a qualitative

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<sup>7</sup> ESRB (2014), *Operationalising the countercyclical capital buffer: indicator selection, threshold identification and calibration options*, Occasional Paper No. 5.

assessment that takes account of various quantitative indicators that will change over time.

The buffer guide will be a part of the overall assessment of the level of the buffer rate, but will not be a determining factor in the decision. The reason is that the credit gap, calculated using the standardised approach, can sometimes give misleading signals and must therefore be interpreted with caution.

The shortcomings of the standardised approach are, for instance, linked to the statistical method used to estimate the long-term trend for credit in relation to GDP, known as the HP filter<sup>8</sup>, which aims to reflect the long-term sustainable credit level. Because the trend is calculated mechanically, its ability to explain the equilibrium level of credit is deficient. There has been sharp credit growth in Sweden over a lengthy period of time, particularly in the household sector, and this also applies to the credit-to-GDP ratio. Estimating a long-term trend using an HP filter for such a period, particularly when the growth rate is slowing down, as is the case in Sweden today, is particularly problematic. The mechanical trend then continues to increase as a result of the previously high credit growth, which can lead to overestimation of the level of the long-term trend. If this level is not sustainable in the long term, the credit gap and hence the buffer guide too will underestimate the risks in the system and thereby also the need for a countercyclical buffer. One way of reducing the uncertainty in estimating the trend could be to extend the data series by a simple forecast over a certain time horizon before the HP filter is applied. This method has been used by Norges Bank in connection with the central bank advising the Norwegian Ministry of Finance on setting the countercyclical buffer rate in Norway. However, the method only leads to deferring the problems somewhat, but does not solve the fundamental problem associated with the HP filter method. Finansinspektionen thus does not find sufficient grounds to deviate from the standardised approach and apply this method instead.

Another shortcoming is the sensitivity of the method to short-term fluctuations in the GDP trend. The method might indicate a high buffer level in a temporary downturn in GDP in connection with a dip in the economy. The reduction in GDP (the denominator) makes the credit gap larger, given unchanged lending (the numerator). However, such a situation need not be associated with the build-up of cyclical systemic risks.

The analyses of the ESRB and the Basel Committee also show that the credit gap is a less suitable indicator for determining when the buffer should be released. In decisions about releasing or reducing the buffer, it is instead more informative to use high-frequency variables such as indicators that measure the stress level of the financial system. The lack of clear indicators with sound signalling qualities when releasing or reducing the buffer, makes the judgement

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<sup>8</sup> The trend is calculated using a one-sided Hodrick-Prescott (HP) filter with smoothing parameter ( $\lambda$ ) set at 400,000. This is based on an assumption that a financial cycle is four times as long as a normal business cycle.

and qualitative assessments of the authority all the more important in such decisions. According to the ESRB and the Basel Committee, a release or reduction of the countercyclical capital buffer may occur quickly or gradually. In a course of events in which major losses are incurred in the banking system in a short space of time, the buffer should be turned off immediately in order to release capital that can be used to cover such losses and hence reduce the risk of a credit crunch. If, however, the losses arise in a more protracted course of events, the level of the buffer might need to be reduced gradually as the risks are curbed.

#### **2.4 Description of the Basel Committee's standardised approach**

The Basel Committee's standardised approach<sup>9</sup>, which according to Finansinspektionen shall be used to calculate the buffer guide, is based on the credit gap which is a measure of the deviation of the ratio of credit-to-GDP from its long-term trend. An initial step in establishing the credit gap is to calculate the ratio between aggregate credit to the private sector and GDP. The Basel Committee recommends that aggregate credit be defined as broadly as possible so that it also captures credits not granted through traditional bank loans.

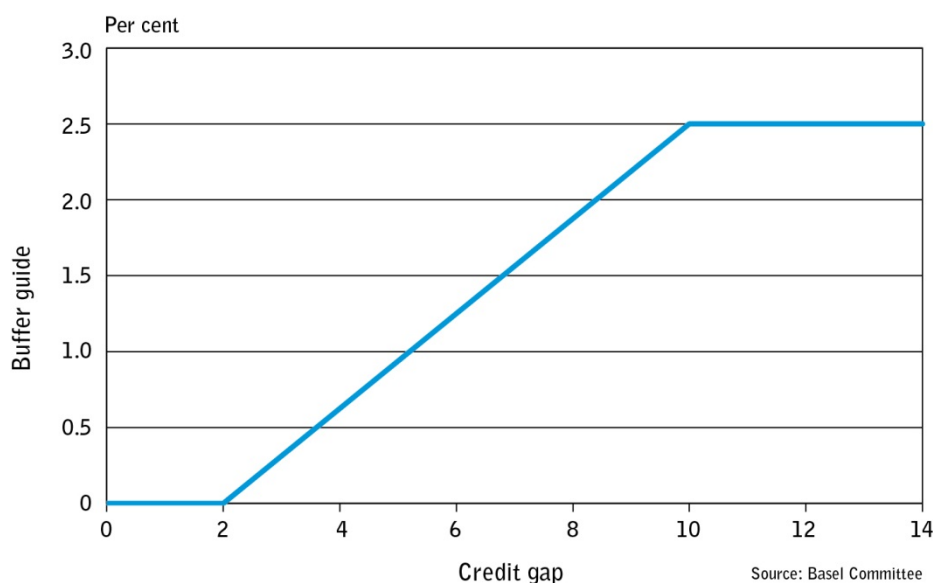
The long-term trend for the ratio of credit-to-GDP is then calculated. The credit gap is the difference between the ratio and the calculated trend, and measures the deviation from trend in percentage points. A large, positive credit gap is an indication that credit has increased to an excessive level in relation to GDP. It can imply that risks in the financial system have increased and that there is thus reason to activate or increase the countercyclical capital buffer.

In the final step, the credit gap is converted to a buffer guide. A quantitative rule specifies how the credit gap and buffer guide are to stand in relation to each other. According to the rule, the buffer guide shall be greater than zero when the credit gap is higher than 2 per cent, and then increase linearly with the credit gap until the buffer reaches its maximum level (e.g. 2.5 per cent of the risk-weighted exposure amount) when the credit gap reaches 10 per cent. As mentioned, 2.5 per cent does not constitute the maximum level for the countercyclical buffer rate. Finansinspektionen may set a buffer rate that is higher than 2.5 per cent when motivated. However, 2.5 per cent is the upper limit for the buffer rate to apply automatically for foreign branches with credit exposures in Sweden. The linear function that determines the relationship between the credit gap and buffer guide is shown in diagram 1.

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<sup>9</sup> BCBS (2010), *Guidance for national authorities operating the countercyclical capital buffer*.

### 1 Relationship between the credit gap and buffer guide according to the standardised approach



## 2.5 The countercyclical buffer rate and the buffer guide for Sweden

**Finansinspektionen's position:** The countercyclical capital buffer for Sweden shall be activated and the buffer rate shall be set at 1 per cent given the present economic conditions. This buffer rate shall be applied when calculating the institution-specific countercyclical buffer as of 13 September 2015. The countercyclical buffer guide for Sweden, which forms part of setting the buffer rate, is set at 1.25 per cent given the present economic conditions.

**Consultation memorandum:** Contained the same proposals with the exception that the countercyclical buffer guide amounted to 1.5 per cent based on the information available at the time.

**Consulted bodies:** *The Riksbank* welcomes Finansinspektionen's decision to activate the countercyclical buffer and finds that this is justified in light of the increased systemic risks and with the purpose of strengthening the resilience of the banks. However, the Riksbank is of the opinion that the countercyclical buffer rate should be set at 2.5 per cent. This is because of the developments on the housing market in recent years as well as the high and growing indebtedness in the Swedish household sector. Furthermore, the Riksbank does not share Finansinspektionen's view that measures addressing structural systemic risks, such as an increase in the risk weight floor, justify setting the buffer rate at a lower level than the buffer guide because such measures serve different purposes in macroprudential policy. Finally, the Riksbank finds that it would be desirable to have a shorter phasing-in period than 12 months. The



fact that credit has increased sharply over a lengthy period of time could provide specific grounds for this.

*The Swedish Bankers' Association* opposes Finansinspektionen's proposal that the countercyclical buffer rate should be 1 per cent. Neither current credit growth nor the credit growth that can be anticipated once the requirement comes into effect in the autumn of 2015 can justify activating the buffer at present. Problems such as high house prices and hence increasing indebtedness for households are not resolved by means of heightened capital requirements for banks, but require structural reforms.

Furthermore, the Bankers' Association expresses that its assessment is that the buffer guide that forms the basis for Finansinspektionen's proposal regarding a buffer rate of 1 per cent will be considerably lower already in autumn when Finansinspektionen is expected to decide on the level. The downward trend of the buffer guide makes it all the more unfortunate to activate the buffer requirement for the first time. In a situation where the buffer had already been activated, the reduced buffer guide would probably have entailed a reduction in the buffer from a higher level to 1 per cent, and hence a decrease in the banks' capital need. A buffer requirement at present of 1 per cent now leads to the banks' capital need increasing. Instead of releasing capital, the banks will thus need to build up capital, which will further restrain growth.

Furthermore, the Bankers' Association expresses that the buffer requirement will affect the real economy, mainly because it hampers business and industry growth, investments and demand. This is in turn due to the buffer requirement reducing the banks' incentive to grant loans, particularly to corporate customers, whose loans have higher risk weights. The Bankers' Association thus finds it inappropriate to introduce a countercyclical buffer requirement, partly due to the current state of the economy, and partly because Finansinspektionen has already announced that the risk weight floor for mortgages is to be increased to 25 per cent.

*The Swedish Savings Banks Association* essentially concurs with the opinion of the Swedish Bankers' Association on the proposal.

*The Swedish National Debt Office* opposes the activation of the countercyclical buffer. The current situation is not characterised by a sharp upturn phase in which excessive credit growth poses a systemic risk. In addition, the general state of the economy shows a clear-cut picture, with a clear downward trend in underlying inflation and very low resource utilisation in the past few years. The National Debt Office goes on to express that the increase in the risk weight floor for mortgages, on top of tightening capital requirements in general, constitutes a further argument that the buffer should not be activated. Both of these measures could, in the opinion of the National Debt Office, be said to tackle the same risks and can thus largely be considered to substitute each other. Therefore, the increase in the risk weight floor ought to be a sufficient and more appropriate measure because it specifically targets the type of credit

that has given rise to the bulk of the observed risks. The countercyclical buffer has a more imprecise effect because it also entails increased capital requirements for corporate lending, which cannot be considered justified on the basis of how such lending has developed in recent years. In light of the prevailing state of the economy and the tightening of capital requirements now under way, particularly the increase in the risk weight floor for mortgages, the National Debt Office believes that the countercyclical buffer should not be activated at present.

*The Association of Swedish Finance Houses* believes that Finansinspektionen should consider setting the buffer rate at a lower level than 1 per cent. The Association shares the view that the countercyclical buffer rate is a blunt instrument, since the buffer rate only takes account of aggregate credit growth, and not of the fact that credit growth differs greatly between different areas. In the current situation, with mortgage lending having grown sharply but not corporate lending, the Association finds that the countercyclical buffer rate ought to be set as low as possible, while at the same time other, more targeted measures should be taken to control mortgage lending.

*The Confederation of Swedish Enterprise* expresses that the countercyclical capital buffer should not be set too high initially. This is because a large number of measures have been implemented to manage the risks associated with the household indebtedness, and small companies are probably hit harder since they have no alternatives to bank loans. The countercyclical capital buffer is in principle a good instrument, but it is important to look at broader measures than aggregate credit growth alone when setting buffer levels. Credit growth today is primarily driven by household mortgages, while credit growth in the non-financial corporate sector is much lower. Moreover, corporate lending is affected to a greater degree by increased capital requirements because of its higher risk weights. The countercyclical buffer is thus not the most efficient instrument from an economic point of view for strengthening the resilience of banks at present.

*The Financial Sector Union of Sweden* finds that countercyclical buffer rates can be a good tool for creating a more stable financial system. Furthermore, it expresses that the level of the rate at a given time must be put in relation to the total capital requirement imposed on the banks.

*The Swedish National Board of Housing, Building and Planning* supports Finansinspektionen's proposal.

*The Swedish Competition Authority* and *Kommuninvest* have no views on the exact level of the countercyclical buffer rate. *The Swedish Accounting Standards Board* and *FAR* (the Professional Institute for Authorised Public Accountants) have no views on the proposal.

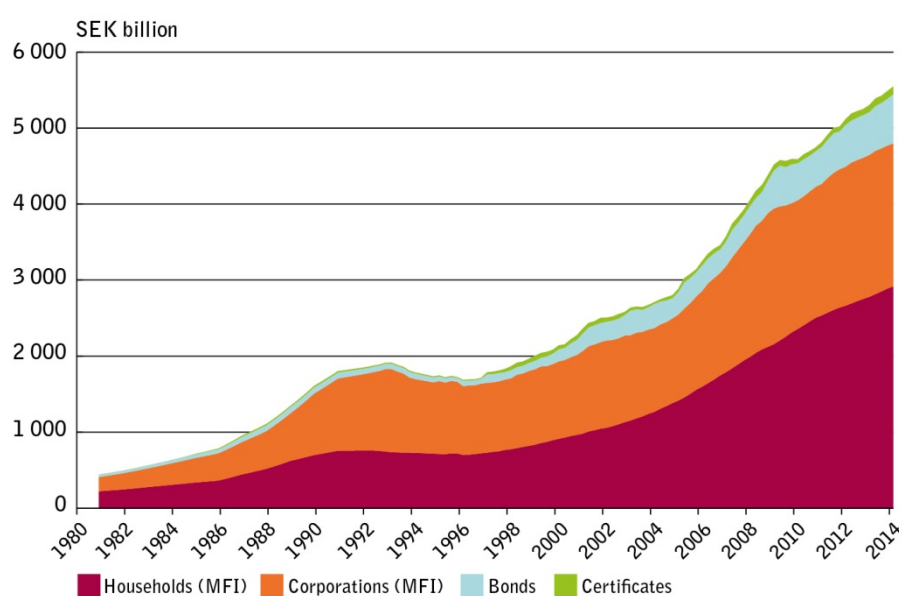
**Finansinspektionen's grounds:** According to the standardised approach, the countercyclical buffer guide in Sweden is 1.25 per cent for the first quarter of



2014, which is the most recently available outcome. The following describes the stages for deriving this buffer guide. All amounts are in nominal terms. Appendices 1 and 2 include further details about how the calculations were performed.

As already mentioned, the Basel Committee recommends that the credit measure used for calculating the credit gap should be as broad as possible so that it also captures credits not granted through traditional bank loans. For Sweden, the measure of total credit to the private sector covers all corporate and household lending issued through monetary financial institutions (MFI)<sup>10</sup> and the total market financing of the corporations.<sup>11</sup> The market financing of corporations has been defined as the value of all outstanding corporate bonds and certificates traded on the fixed-income market.<sup>12</sup> Diagram 2 shows the development of credit in Sweden over time in nominal terms.

**2 Lending to the private sector in Sweden**



Source: FI, Statistics Sweden and the Riksbank

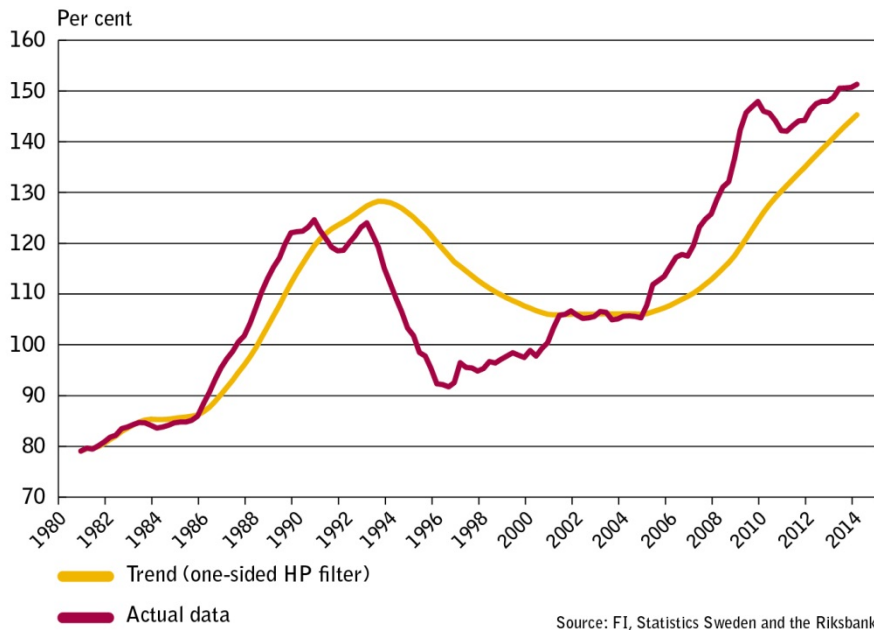
The credit measure in diagram 2 has been used to calculate the credit-to-GDP ratio, as shown in diagram 3. It can be ascertained that total corporate and household lending in Sweden has risen faster than GDP in the 2000s. Total lending to the private sector currently amounts to around 150 per cent of GDP over the past year in Sweden.

<sup>10</sup> Monetary financial institutions include banks, mortgage institutions, financial companies, municipal and corporate-financed institutions, monetary securities companies and monetary investment funds (money market funds).

<sup>11</sup> Intragroup loans for non-financial corporations have been excluded from the credit measure because they are often based on other motives than financial ones (e.g. tax reasons).

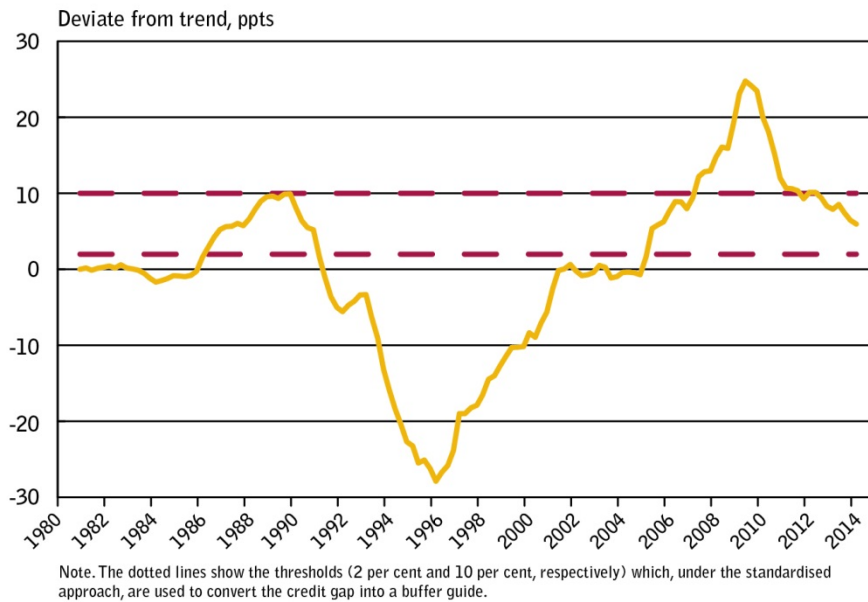
<sup>12</sup> For more credit data information, see Appendix 1.

### 3 Credit in relation to GDP, actual data and trend



The total credit-to-GDP ratio is thus still at a historically high level. The calculation of the credit gap indicator, i.e. the deviation of the ratio from the calculated long-term trend, shows that the ratio is also higher than the trend since the gap is positive (see diagram 4).

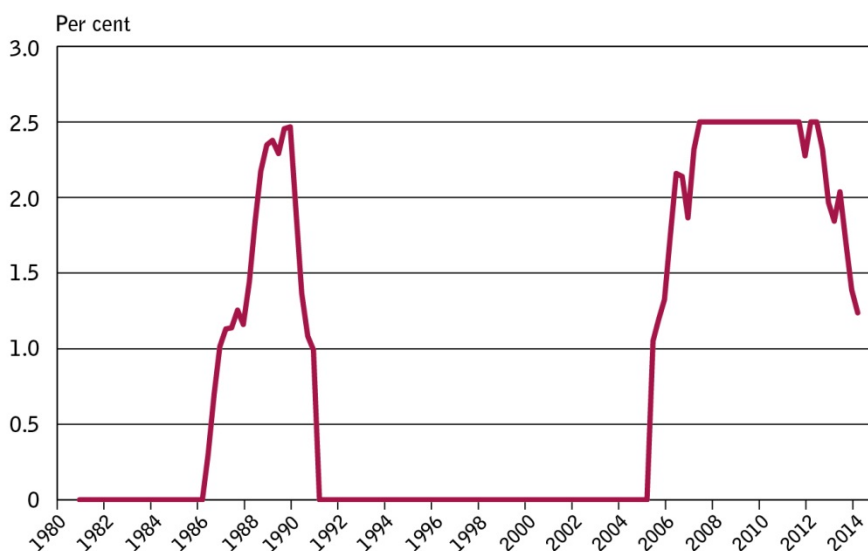
### 4 Credit gap according to the standardised approach



Historical buffer levels in Sweden can be calculated by applying the quantitative rule that determines the relationship between the credit gap and the buffer level. The result of the calculation is shown in diagram 5. The calculations show that the countercyclical capital buffer would have been activated on two occasions during the period 1980-2014. In 1986 ahead of the

crisis of the 1990s, and in 2005 ahead of the latest financial crisis. If the tool had been available in the 2000s, the buffer rate according to the standardised approach would have been 2.5 per cent from 2005 and a number of years onwards. The credit gap has, however, decreased somewhat in recent years, giving a lower buffer guide. The result for the first quarter of 2014 indicates that the current buffer guide amounts to just over 1.25 per cent.

### 5 Buffer level according to the standardised approach



Source: FI, Statistics Sweden and the Riksbank

#### 2.5.1 Other considerations

Finansinspektionen is of the opinion that the buffer guide for Sweden should be set at 1.25 per cent. Finansinspektionen sets the value on the basis of a calculation made using the standardised approach of the Basel Committee, as described above.

Due to the deficiencies in the standardised approach, as described in section 2.3, the buffer guide should not be the only indicator taken into account when setting the countercyclical capital buffer. The buffer guide is an important but not decisive factor in Finansinspektionen's overall assessment of an appropriate buffer rate level. The assessment thus needs to be supplemented by, on the one hand, information about other relevant indicators that could signal the build-up of systemic risks and, on the other hand, qualitative assessments.

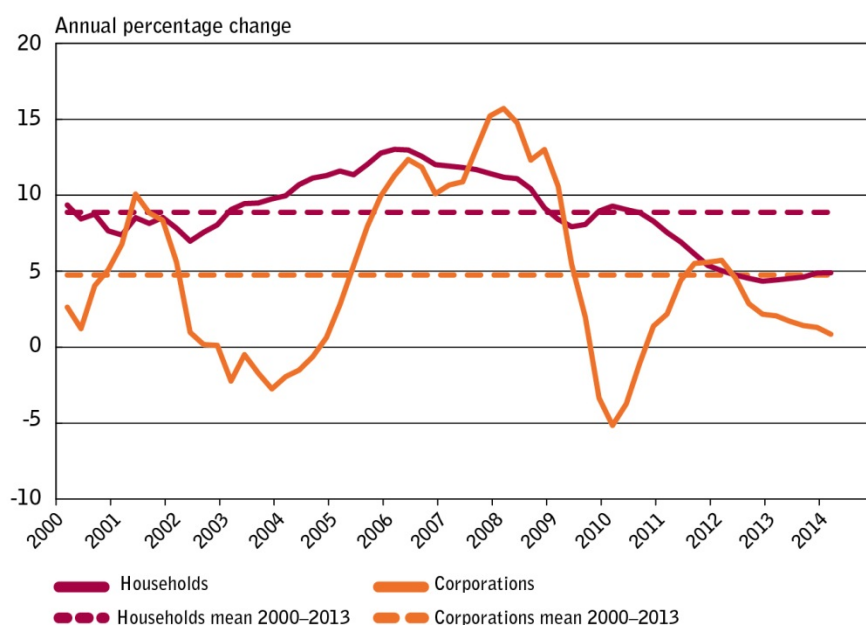
#### *Development of corporate and household debt*

In order to gain a better insight into the development of credit over time, it is interesting to break down the aggregate credit gap measure and analyse how credit to the household and corporate sectors, respectively, has developed.

The most important conclusion that can be drawn from this analysis is that the rate of lending to households and corporates, respectively, varies in Sweden. In recent years, corporate lending has mainly increased at a rate that is close to or even lower than nominal GDP growth, while lending to households, despite a certain slowdown in recent years, continues to rise at a faster rate than GDP growth.

The growth rate in lending to households and corporates, respectively, in Sweden is shown in diagram 6. According to Financial Market Statistics, household loans from MFI have on average increased by almost 9 per cent annually over the period 2000–2013. The growth rate in corporate lending from MFI has been lower on average, at just under 5 per cent. Compared with household lending, corporate lending shows greater volatility and a clearer link to the developments in the business cycle. The sharp volatility in corporate lending could also be a sign of the procyclicality in the lending of credit firms, with major credit expansion in boom times and heavy tightening in downturns.

**6** Growth rate in lending to households and corporations from MFIs



Source: FI, Statistics Sweden and the Riksbank

It is clear that the development of the total indebtedness for the private sector in Sweden has mainly been driven by household borrowing. Since the financial crisis, however, the growth rate for both household and corporate credits has decreased. Diagram 6 shows that both household and corporate lending through MFIs are currently below the historical averages. In recent years, total lending has slowed down and the growth rate today is clearly much lower than before the financial crisis, when the rate of increase in lending reached all-time highs (see table 1).

Table 1 shows the annual rates of increase for household and corporate lending, respectively, and for total lending in 2013 and the first quarter of 2014.

**1 Growth rates in lending to households and corporations (excluding and including the market financing of corporations)**

Annual percentage change

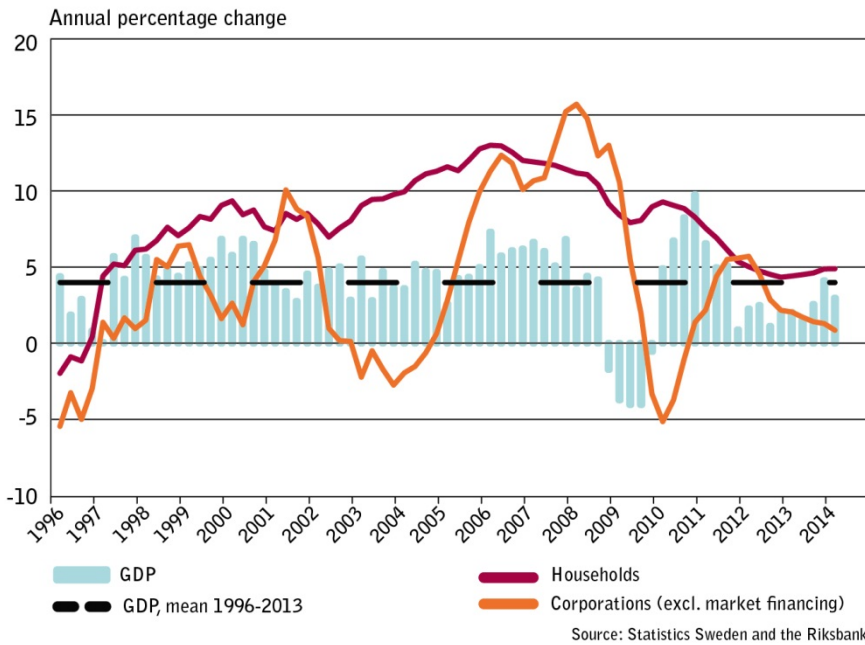
	Households	Corporations (ex. market)	Corporations (inc. market)	Total credit granting/lending
Q1 2013	4.4	2.1	2.9	3.7
Q2 2013	4.5	1.7	3.0	3.8
Q3 2013	4.6	1.4	3.0	3.8
Q4 2013	4.9	1.3	4.0	4.4
Q1 2014	4.9	0.8	4.2	4.6
<b>FY 2007</b>	11.7	12.5	12.1	11.9
<b>FY 2013</b>	4.6	1.6	3.2	3.9

Source: FI, Statistics Sweden and the Riksbank

In 2013, aggregate lending rose by almost 4 per cent compared to almost 12 per cent in 2007, when the credit expansion of the 2000s was close to its peak. Despite this stabilisation, however, the loan stock of households is still increasing faster than that of corporations, in terms of corporate lending both excluding and including market financing.

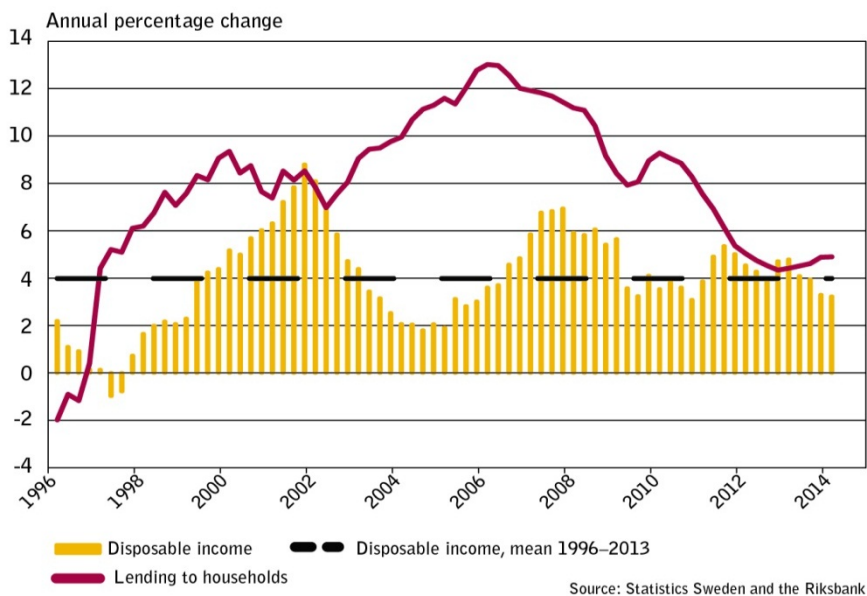
Since the end of the 1990s, lending to households has continually increased and growth rates have clearly outstripped nominal GDP growth (see diagram 7). Corporate lending (excluding market financing) tends instead to develop the same way as the business cycle and hence GDP growth. As was the case for nominal GDP growth, corporate lending waned in the wake of both the IT bubble and the latest global financial crisis, while household lending was affected to a very minor extent by these economic downturns.

**7 Growth rate in lending to households and corporations and nominal GDP growth**

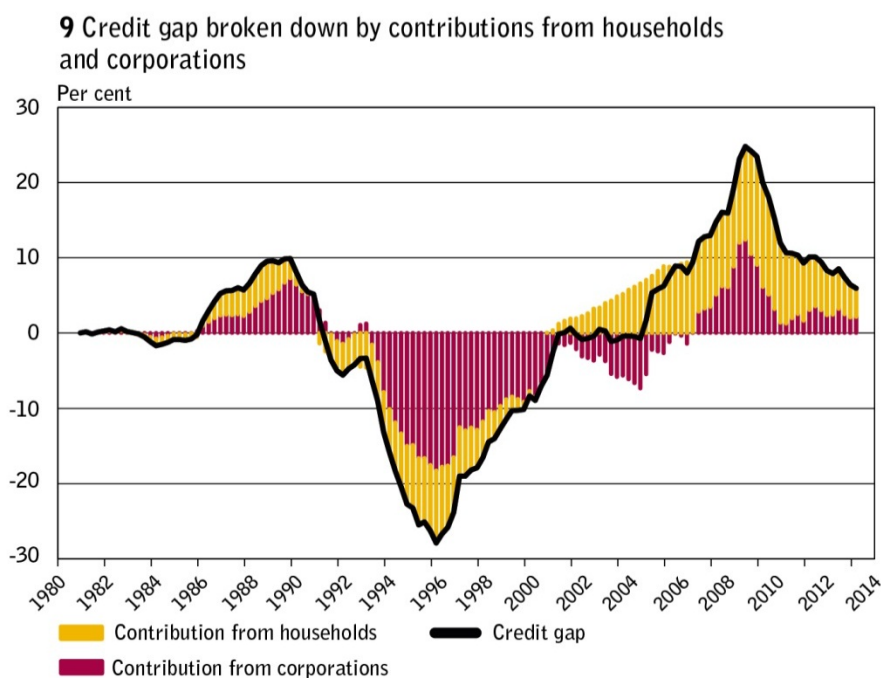


A comparison of credit growth in the household sector with the development of household nominal disposable income shows that household credits have increased at a faster rate than income (see diagram 8). However, this has stabilised to a certain extent in the last few years. Disposable income has increased at a healthy rate, close to the historical average, while growth in household credits has instead slowed down to be more in line with disposable income.

**8 Growth rate in lending to households and nominal disposable income**



As a supplement to studying actual growth rates, the respective contributions of households and corporations to the total credit gap can also be calculated (see diagram 9). Household credit growth accounts for over two thirds of the total credit gap. In other words, lending to households contributes the most to the credit gap, both now and a few years historically.



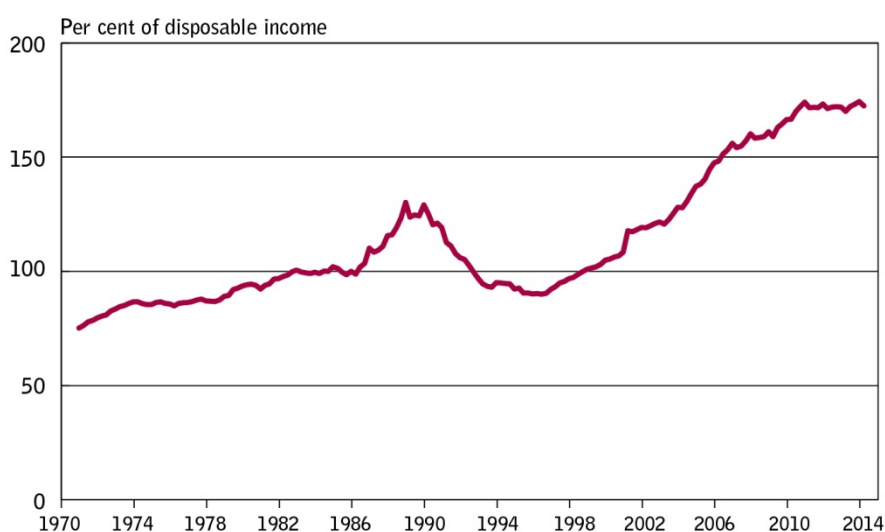
Note. Contributions from households and corporations sum up to the total credit gap

Source: FI, Statistics Sweden and the Riksbank

As expressed above, households have contributed the most to the debt build-up in the private sector in Sweden in recent years. However, it is also clear that a certain degree of stabilisation has occurred after the financial crisis. The indicators described above suggest that credit growth does not appear to be excessively high in Sweden today. At the same time, household indebtedness is high. Total household debt currently amounts to around 175 per cent of disposable income, which is a high level in both a historical and international perspective (see also diagram 10). This entails a build-up of risk in the Swedish economy that could pose a risk to the stability of the financial system.



## 10 Debt ratio of Swedish households



Source: Statistics Sweden and the Riksbank

The analysis in this section shows that total lending remains high in Sweden, but that the growth rate has slowed down and is currently relatively moderate, particularly in the corporate sector, but also in the household sector. Corporate lending has slowed down more than household lending and is currently growing at around the same rate as nominal GDP. Corporate lending has also proven to fluctuate more with the business cycle. According to the standardised approach, the current relatively moderate credit growth in the corporate sector is making a positive contribution to the credit gap (see diagram 9), but this should be seen in light of the fact that the calculation in the standardised approach is affected by the very low lending to the corporate sector almost entirely throughout the 1990s. Taking this into consideration, there does not seem to be a credit-driven build-up of risk in the corporate sector. As a counterweight, there is cumulative high indebtedness among households that could trigger or amplify an economic downturn and pose a risk to financial stability.

Finansinspektionen's latest mortgage report<sup>13</sup> showed that Swedish households have high resilience and repayment ability, even in stressed situations such as in interest rate hikes or increased unemployment. This implies that the risk of major credit losses on mortgages is still limited. However, it is important to bear in mind that, although households could continue to pay off their loans in a stressed financial situation, indirect negative effects could arise in other parts of the economy. In a crisis, it is probable that households would cut back on other expenditure in order to pay their loans or to restore their balance sheets, and household consumption could consequently decrease considerably, and hence economic growth. This could in turn affect corporations with a negative impact on their profitability and ability to pay their loans, and involve

<sup>13</sup> FI (2014), *the Swedish mortgage market 2014*. Published on fi.se on 10 April 2014, FI ref. 13-7755.



increased risks of credit losses in the corporate loan portfolios of banks. In addition, there is of course the risk that the profitability and repayment ability of corporations could decline for other reasons, such as reduced exports. In light of this, it may therefore be desirable for the banks to build up a buffer to cover potential credit losses also in exposure classes other than household exposures. Finansinspektionen is therefore of the opinion that the banks need to have a countercyclical capital buffer to make them more resilient to potential future credit losses.

#### *Other quantitative indicators*

According to the ESRB's guidelines, designated authorities shall, in their assessment of systemic risks linked to excessive credit growth, in addition to the credit gap also take account of other quantitative indicators. These can supplement the overall picture and signal whether such risks have been or are being built up. ESRB recommends that a number of different categories of indicators should be followed up and taken into account when deciding on the appropriate level for the countercyclical capital buffer. These include various measures of credit developments, measures that indicate any potential overvaluation of property prices, measures of external imbalances, measures that show the strength of bank balance sheets, measures of private sector debt burden, and measures that could indicate potential mispricing of risk. Finansinspektionen has, by reason of these guidelines, decided to focus on a number of indicators which, in addition to the credit gap, are considered relevant for Sweden. A brief description of the selected indicators and their development over time is provided below.<sup>14</sup>

a) House prices in relation to disposable income, current prices

In Sweden, house prices have increased at a slightly slower rate than the disposable income of households over the entire period 1980–2014 (see diagram B 3.1). Throughout most of the 1980s, house prices rose more slowly than income. In connection with the Swedish banking crisis at the beginning of the 1990s, house prices fell relatively sharply, one reason relating to higher real interest rates on mortgages, but have subsequently been on an upward trend. Following the financial crisis, however, house prices have grown more slowly than disposable income. It can thus be ascertained that, although Swedish house prices have risen sharply in the last few decades, also the disposable income of households has progressed at a decent rate over the same period. Thus, from this point of view, house prices do not appear to be overvalued.

b) Current account and financial savings in the public sector as a share of GDP

The current account is the difference between what is produced and consumed in a country, and can be seen as a rough measure of the

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<sup>14</sup> See Appendix 3 for further information.

country's total savings. A current account deficit might signal an imminent crisis. The Swedish current account surplus has been large since the mid-1990s (see diagram B 3.2). While public sector savings, i.e. public sector revenues minus its expenses, as a share of GDP has indeed fallen below zero in the most recent outcomes, it has generally been positive since the crisis of the 1990s. Moreover, the Swedish deficit is still low in an international comparison. These indicators suggest that currently there are no external imbalances in the Swedish economy as a whole, which contributes positively to the repayment ability of households and corporations.

c) Tier 1 capital in relation to total assets and common equity Tier 1 capital ratio

Tier 1 capital in relation to total assets and common equity Tier 1 capital in relation to total risk-weighted assets (the CET 1 capital ratio) for the four major Swedish banks have increased in recent years (see diagram B 3.3). The capital levels of banks have thus increased both when assets are measured in absolute terms and when account is taken of the riskiness in the banks' portfolios. This suggests that resilience in the Swedish banking sector has strengthened and that the banks are better equipped to cover potential losses during periods of high stress in the financial system.

d) Interest rate ratio of households

The interest rate ratio shows the proportion of household disposable income spent on interest expenses, that is, households' running expenses for loans, before interest rate deductions. Thus, the interest rate ratio provides an indication of the strength of the balance sheet of households. In Sweden, the interest rate ratio has shown a downward trend from the start of the 1990s, which is largely due to interest rates also falling over the same period (see diagram B 3.4). At the same time, the nominal disposable income of households has increased at a decent rate in recent years. Interest expenses currently amount to 5.5 per cent of disposable income, which is a low level that reflects today's low mortgage rates. Consequently, households allocate a very small proportion of their income to interest expenses, indicating that they can accommodate increased loan expenses that might be caused by, for example, future interest rate increases.

e) Real equity prices

Equities are seen as a risky asset compared with other assets, such as government bonds. During periods of great optimism in financial markets, market participants tend to increase their risk-taking, and thereby the risk of overvaluation of the equity market increases too. Equity market performance, adjusted for inflation, should thus be able to signal when the risk of mispricing risk increases. However, this indicator should be interpreted with some caution, because a sharp upswing in real equity prices need not necessarily be driven by or

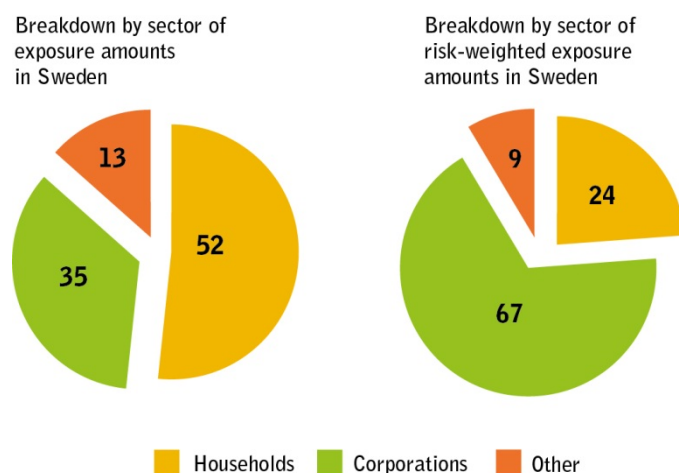
linked to excessive credit and the build-up of systemic risk (this was the case, for instance, when the IT bubble burst at the beginning of the 2000s). As shown in diagram B 3.5, real equity prices have risen relatively sharply since the financial crisis. Finansinspektionen is of the opinion that at present this is not in itself unreasonable, particularly in light of the low interest rates.

*The effect of the countercyclical capital buffer on the capital requirement for household and corporate exposures, respectively*

As mentioned previously, the credit gap is based on a broad measure of credit and includes not only lending from financial institutions, but also market financing. The reason for this is that banks and other credit firms could be affected in one way or another by the consequences of a period of excessive credit growth, despite them not having contributed to inflating such excessive credit growth. Credit firms might thus be forced to hold more capital also in a scenario where they themselves have exercised restraint in lending.

In addition to the measure of credit being broader than the exposures to which the buffer is to be applied, there is a further aspect to take into consideration in this context. The countercyclical capital buffer will be applied to the total risk-weighted exposure amount in Sweden. Thus, the buffer's impact in absolute terms will be greater on corporate exposures than on household exposures. This is shown by the breakdown between the various sectors of non-risk-weighted and risk-weighted credit exposures at aggregate level for the four major banks, see diagram 11.

**11** The major banks' aggregate non-risk-weighted and risk-weighted exposure amounts for credit risk, broken down by different sectors (per cent)

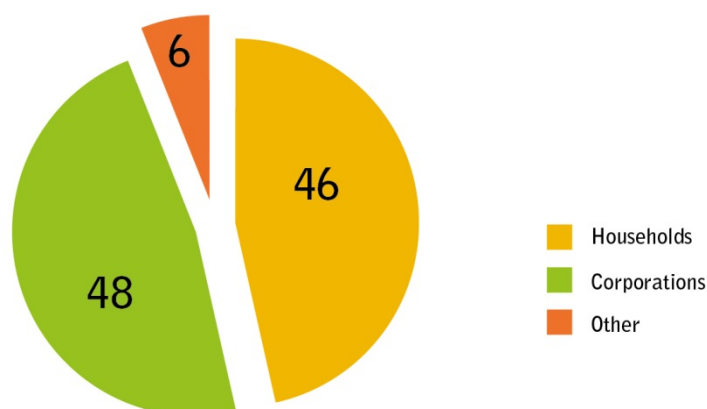


Household exposures account for just over half of the major banks' total exposure amount for credit risk, while corporate exposures account for around one third. The breakdown appears differently in terms of the total risk-weighted exposure amount for credit risk. Two thirds of the major banks' risk-

weighted exposure amounts are attributable to corporations, while barely one quarter is attributable to households. This is in turn due to the fact that corporate exposures have a higher risk weight on average than household exposures. Since the countercyclical buffer rate is applied to the banks' risk-weighted exposure amount in Pillar 1, the effect will therefore be greater for corporate exposures, measured in terms of non-risk-weighted exposure amounts.

In the memorandum regarding capital requirements for Swedish banks that was published on 10 September 2014<sup>15</sup>, it is stated that the calculation of the Pillar 2 basic requirement, which follows from increasing the risk weight floor for mortgages to 25 per cent, should include the countercyclical capital buffer rate for Sweden. The risk weight floor for mortgages thus entails that the household sector's share of the concerned firms' risk-weighted exposure amount in practice becomes larger.<sup>16</sup> This is shown in diagram 12, which can be compared to diagram 11.

**12** The major banks' aggregate risk-weighted exposure amounts for credit risks, taking account of a risk weight floor for mortgages of 25 per cent, broken down by different sectors (per cent)



However, it is still the case that the buffer requirement hits the corporate exposures of banks slightly harder than their household exposures, measured in terms of non-risk-weighted exposure amounts. In this context, it should also be noted that small and medium-sized corporations are those that rely on bank loans the most. Large corporations often have access to market financing as an alternative.

<sup>15</sup> FI (2014), *Capital requirements for Swedish banks*. Published on fi.se on 10 September 2014, FI ref. 14-6258.

<sup>16</sup> In legal terms, the share of the countercyclical capital buffer affected by the risk weight floor does not form part of the countercyclical capital buffer, but is included in the specific own funds requirement in Pillar 2.

The countercyclical capital buffer is, in this respect, a blunt instrument that does not take account of whether credit growth in a certain sector is excessive, but only takes aggregate credit growth into consideration. In general, when the causes of systemic risk can be identified, it is more effective to focus on these causes to better prevent and manage the systemic risks. The analysis presented in the memorandum shows that lending to households has been the driving factor and has contributed the most to credit expansion in Sweden. The fact that the countercyclical buffer has somewhat greater effects on the corporate sector, combined with the fact that there are no indications of any excessive credit expansion in the corporate sector, must therefore also be taken into consideration in the decision regarding the buffer rate.

#### *The effect of raising the risk weight floor for mortgages to 25 per cent*

A determining factor for the level of the countercyclical capital buffer is the overall assessment of cyclical systemic risks that are linked to excessive credit growth. This applies regardless of the total requirement for the firms at a given point in time, because such requirements may aim at managing other types of risk. However, Finansinspektionen finds that it is important, when setting the buffer rate, to also take account of other measures that Finansinspektionen takes to manage systemic risks.

Finansinspektionen's position that the risk weight floor for mortgages is to be increased by 10 percentage points, means that an additional amount of over SEK 40 billion<sup>17</sup> in own funds will be needed to cover the risks in Swedish mortgages. This can be related to the capital requirement of around SEK 11 billion<sup>18</sup> which follows from the introduction of a countercyclical capital buffer of 1 per cent in Sweden.

In Finansinspektionen's view, an increase in the risk weight floor for mortgages suggests that currently the countercyclical buffer need not to be set at too high a level. This does not mean, however, as expressed by the *National Debt Office*, that the two measures can largely be considered substitutes for each other. The risk weight floor, together with other increased capital requirements, has the purpose of addressing systemic risks of a structural nature, in a normal state in the credit cycle. Therefore, these requirements are not normally intended to vary over the credit cycle, which the countercyclical buffer should do. At the same time, it should be pointed out that although this fundamental difference is important, it can in practice be difficult to completely separate cyclical systemic risks from structural ones. This is particularly the case in a situation like the present, with a number of different measures being taken simultaneously.

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<sup>17</sup> FI (2014), *Capital requirements for Swedish banks*. Published on fi.se on 10 September 2014, FI Ref. 14-6258, based on the data in table 7.1.

<sup>18</sup> This assumes no increase in the risk weight floor and no effect through the current floor of 15 per cent Based on the information in table 2.

On the whole, Finansinspektionen maintains that by increasing the risk weight floor for mortgages to 25 per cent, the need for a high countercyclical capital buffer decreases. Since the largest part of the credit gap is explained by growth in credit to households, an increase in the risk weight floor appears to be a much more appropriate tool. This tool can take into account not only the change in credit, but also the cumulative risks.

### 2.5.2 *Finansinspektionen's view on the feedback received*

By reason of the feedback received, Finansinspektionen wishes once again to clarify that the purpose of the countercyclical buffer is to strengthen the resilience of firms and ensure that the banking system as a whole has sufficient capital to sustain the flow of credit to households and corporations. This is achieved by increasing the buffer during periods of systemic risk build-up. The countercyclical buffer is not a tool to be used in order to affect the economy or asset prices, but aims to prevent and manage systemic risks linked to excessive credit growth. These risks vary over time and do not necessarily coincide with the economy in general.

The focus of the countercyclical buffer is thus on the cyclical systemic risks that can arise after a long period of rapid credit expansion. The analysis in this memorandum shows that Sweden over a long period has had a strong credit growth which, according to Finansinspektionen's assessment, has built up risks in the financial system. The fact that credit growth is now occurring at what can be considered as a more normal rate does not mean that the systemic risks created by such a credit expansion have fully disappeared. Finansinspektionen sees risks in the sustained indebtedness of households.

The analysis shows that, had the countercyclical capital buffer been in place already before, the buffer would have been activated as early as in 2005 and amounted to at least 2.5 per cent. This does not necessarily entail, as expressed by the *Bankers' Association*, that the buffer would have been lower than one per cent or even released at present. A reduction or release of the countercyclical buffer would only have occurred if the systemic risks linked to excessive lending had substantially decreased, or if credit losses had materialised. The banking system would then already have had a buffer to lean on in the event of the risks materialising. There is no such buffer today, however.

Finansinspektionen wishes to emphasise once more that the decision regarding the countercyclical buffer rate is not made on the basis of the credit gap indicator alone. This indicator has its shortcomings and can be misleading, which is why it shall not govern the decision or lead to setting the buffer rate in a mechanistic way. Finansinspektionen's decision is based on a qualitative overall assessment of the cyclical risks linked to the high credit growth that has taken place and the risks this entails.



It has already been ascertained that the buffer requirement might affect corporate credits to a greater extent than household credits, even though it is the household sector that has primarily driven credit growth. At the same time, it is mainly in the corporate portfolios of banks that the risk of incurring potential credit losses is considered higher. On the whole, Finansinspektionen finds that this suggests that activating the countercyclical buffer is justified, but that it is reasonable not to set the buffer rate too high.

Finansinspektionen does not share the view that the countercyclical buffer requirement will hamper economic growth. It can be ascertained that the effect of the buffer requirement in relation to the banks' capital requirements as a whole is small. A buffer rate of 1 per cent should not have a curbing impact on the banks' incentive and ability to supply the real economy with credit. On the contrary, a well-capitalised banking sector that is equipped to deal with systemic risks – both cyclical and structural – benefits from this through greater market confidence, better funding possibilities and probably also lower funding costs.

### 2.5.3 Overall assessment

The countercyclical buffer is to be built up when credit growth is high, and the possibilities for banks to build up a capital buffer are favourable. Activating the countercyclical capital buffer entails the banks holding a buffer to cover potential losses when a crisis strikes, while at the same time maintaining the ability to continue providing credit to the real economy.

Currently, credit growth does not appear to be excessive in Sweden. The growth rate for corporate lending is lower than nominal GDP growth. For household credits, the growth rate is slightly higher than nominal GDP growth, but has slowed down from previous levels and is growing in line with disposable income. At the same time, household indebtedness remains high in both a historical and international perspective. The credit expansion that has taken place for a number of years poses risks to the financial system and the real economy. Finansinspektionen finds that there are grounds for activating the countercyclical capital buffer in Sweden, given the risks overall and present economic circumstances. However, Finansinspektionen does not find that there are motives to have a shorter phasing-in period for the buffer than that stipulated by law.

When setting the buffer rate, it is important to also take account of other measures that Finansinspektionen will take to manage systemic risks. For example, Finansinspektionen will take account of the increase in the risk weight floor for mortgages. Finansinspektionen finds that increased risk weights for mortgages, combined with an activation of the countercyclical capital buffer, is an appropriate and effective approach for raising the resilience of the banks without simultaneously increasing too much the capital requirements for corporate lending.

Finansinspektionen's overall opinion, taking account of the information provided by the credit gap, Finansinspektionen's assessment regarding the development of and sustainability in credit growth, and the imminent increase in the risk weight floor, is that the countercyclical buffer rate in Sweden based on present economic conditions shall be 1 per cent.

#### 2.5.4 *The quarterly procedure for setting the countercyclical buffer rate*

**Finansinspektionen's position:** Finansinspektionen now sets the countercyclical buffer rate through issuing regulations. New regulations will be issued when Finansinspektionen assesses that the rate now decided needs to be changed. In cases where Finansinspektionen finds that no change is needed to the rate stipulated in the regulations, the Board of Directors of Finansinspektionen will decide on this on a quarterly basis and the Board's decision will be published on Finansinspektionen's website.

**Consultation memorandum:** Only set out that a decision regarding setting the countercyclical buffer rate is a matter of setting standards and shall therefore be made in the form of regulations.

**Consulted bodies:** *The Swedish Bankers' Association* expresses that, in the consultation memorandum, Finansinspektionen does not provide a more detailed description of the quarterly procedure for setting the countercyclical buffer rate and the countercyclical buffer rate. The Bankers' Association assumes that the countercyclical buffer rate will be set on a quarterly basis through a decision on a regulation, and that such a decision will be preceded by the customary consultation procedure in accordance with section 4 of the Regulatory Impact Assessment Ordinance (2007:1244). This applies irrespective of whether the countercyclical buffer rate is lowered, raised or maintained.

**Finansinspektionen's grounds:** Now that Finansinspektionen is setting the countercyclical buffer rate for the first time, this is carried out, as described above, through issuing regulations. Going forward, Finansinspektionen will, in accordance with the responsibility of the authority pursuant to Chapter 7, section 1 of the buffer act, regularly assess which buffer rate ought to apply for the following quarter. In cases where Finansinspektionen finds that the rate set out in the regulations shall continue to apply, there is however no reason for Finansinspektionen to issue new regulations in this regard. In such cases, Finansinspektionen's Board of Directors will instead decide that the previously stated buffer rate shall continue to apply. This decision will be published on Finansinspektionen's website.

In cases where Finansinspektionen finds that it is motivated to consider a change in the buffer rate, new regulations will be drawn up. A proposal for regulations will in such cases be submitted for consultation in the customary manner. Finansinspektionen is of the view that the preparation requirement in



the Regulatory Impact Assessment Ordinance shall only apply in cases where a change is needed in the regulations now decided.

### **3 Impact assessment**

The fact that Finansinspektionen is deciding on activating the countercyclical capital buffer through regulations naturally entails consequences for the firms concerned and society at large. The purpose and background of the decision have been described in previous sections.

As set out in section 1, the countercyclical buffers form part of the new, EU-wide capital requirement regulations (CRD 4). Sweden may thus not refrain from introducing this regulation. However, the buffer rate to apply at any given time is a national decision.

Below, Finansinspektionen describes the consequences that follow from the specific buffer rate decided. The section starts with an account of which firms are affected, and then goes on to describe the consequences for these firms. Furthermore, the consequences for consumers, investors and the national economy are described. Finally, the consequences for Finansinspektionen are described.

#### **3.1 Feedback from the consulted bodies**

*The Swedish Better Regulation Council* supports the proposal because the purpose of the proposal is achieved in a straightforward manner at relatively low administrative costs for firms. In the view of the Regulation Council, it is reasonable to see the current proposal for new regulations regarding the countercyclical buffer as further pinpointing requirements that should essentially already be known to the firms concerned. The administrative costs that could ensue from implementing the Capital Requirements Directive reasonably result from the proposed regulations previously submitted for consultation. The Regulation Council does not find that clarifying the level at which the capital buffer should be is in itself a factor that would give rise to substantially increased administrative costs. Furthermore, the Regulation Council finds the impact assessment acceptable.

*The Association of Swedish Finance Houses* finds that the impact assessment analysis should contain a broader analysis covering the smaller and less specialised credit institutions. Considering that there is no credit-driven risk build-up in the corporate sector while at the same time the buffer requirement has the greatest impact on corporate credits, which have higher risk weights, even a low buffer rate can give misleading steering signals and negative effects on corporate lending. According to the Association, this affects in particular small and medium sized enterprises, which do not have access to market funding, but also their creditors which are specialised in corporate financing, such as the many financing companies targeting SMEs.

## 3.2 Consequences for financial institutions

### 3.2.1 *Firms affected*

The countercyclical buffer rate shall be used by credit institutions, investment firms, Svenska skeppshypotekskassan, fund management companies with discretionary portfolio management and AIF managers licensed to conduct discretionary portfolio management when calculating the institution-specific countercyclical capital buffer. This affects around 91 banks, 43 credit market companies, 121 investment firms, 30 fund management companies with discretionary portfolio management, 4 AIF managers with discretionary portfolio management and Svenska skeppshypotekskassan, i.e. around 290 firms.

Finansinspektionen has decided that small and medium sized investment firms, fund management companies with discretionary portfolio management and AIF managers with discretionary portfolio management shall be exempted from the requirement to maintain an institution-specific countercyclical capital buffer. Around 155 firms will therefore be covered by this exemption. Adding to that are also groups that are exempted if the groups only consist of firms which, at individual level, are exempted from the requirement. As of the first quarter of 2014, this means that 145 firms will be exempted from the requirement to maintain an institution-specific countercyclical capital buffer and 10 firms (7 investment firms and 3 fund management companies with discretionary portfolio management) will be covered by the requirement to maintain an institution-specific countercyclical capital buffer.

### 3.2.2 *Costs for the firms*

This section describes the estimated effects are described of a countercyclical buffer rate of 1 per cent for the ten largest Swedish credit firms. The effects have been assessed based on data pertaining to the second quarter of 2014 for the major banks, and the full-year 2013 for the other six firms.<sup>19</sup> The calculations pertain to the consolidated level.

The firm-specific buffer rate has been estimated on the basis of reported data received according to the EU-wide instructions for Common Reporting (COREP) as per the second quarter of 2014. The share of concerned credit exposures in Sweden for each firm has been calculated as follows<sup>20</sup>:

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<sup>19</sup> This means that account has been taken of the effects of the capital requirements regulation, which came into effect on 1 January 2014, on own funds and risk-weighted exposure amounts.

<sup>20</sup> The geographic breakdown has been based on reported data according to COREP, which can differ slightly from the definition in EBA's proposal for a technical standard for this calculation.

- Nordea: 19 per cent
- SEB: 34 per cent
- Swedbank: 57 per cent
- Handelsbanken: 49 per cent
- SBAB: 87 per cent
- SEK: 40 per cent
- Länsförsäkringar: 99 per cent
- Skandia: 41 per cent
- Landshypotek: 91 per cent
- Kommuninvest: 68 per cent

In order to calculate the firm-specific buffer rate, the share of the concerned credit exposures in Sweden, as above, is multiplied by the countercyclical capital buffer rate of 1 per cent. Buffer rates for other countries have not been taken into account. Table 2 below shows the capital need in Swedish kronor resulting from setting the countercyclical capital buffer at 1 per cent .

**2 Capital requirements (CET 1) for the ten largest firms in SEK million, countercyclical capital buffer of 1 per cent**

	Countercyclical capital-buffer (1%)	Current risk weight floor Swedish mortgages (15 %)	Increase of the risk weight floor (to 25 %)	Sum
Nordea	2 636	409	408	3 453
SEB	2 056	309	420	2 786
Swedbank	2 317	803	743	3 863
SHB	1 983	633	604	3 221
SBAB	349	258	260	867
SEK	351	0	0	351
Länsförsäkringar	579	0	115	694
Skandia	163	0	0	163
Landshypotek	167	0	59	226
Kommuninvest	45	0	0	45
<b>Total</b>	<b>10 647</b>	<b>2 413</b>	<b>2 609</b>	<b>15 668</b>

In Finansinspektionen's view, activating the countercyclical capital buffer does not entail any material administrative costs for the firms concerned. The firms must of course update the information relevant for calculating the institution-specific countercyclical capital buffer on an ongoing basis. This is part of the reporting to Finansinspektionen otherwise done by the banks. The regulations for setting the countercyclical buffer are not expected to lead to other consequences in the form of e.g. financial expenses.

### 3.2.3 *Effects for small firms*

As described above, certain small firms are exempted from having to maintain capital to meet requirements for a countercyclical capital buffer. This entails a relief for such firms.

Since all credit institutions will be covered by the regulations, the effect on the competitive situation on the market should be very limited.

In the opinion of Finansinspektionen, there is no need for specific information initiatives in connection with the entry into force, because the firms affected can be considered to be well aware and well informed of the measures and their background.

### 3.3 Consequences for society and consumers

The most important consequence of activating and setting a countercyclical buffer rate is a more stable financial system in Sweden. The purpose of the countercyclical buffer is that it shall be activated at times of excessive credit growth that entails a build-up of risk, and then be drawn down in downturns in order to sustain lending and hence avoid the credit crunch that often occurs when banks incur losses.

The main purpose of the countercyclical capital buffer is consequently to strengthen the resilience of firms and ensure that the banking system as a whole has sufficient capital to sustain the flow of credit to households and corporations, i.e. the real economy, even at times when shocks to the financial system could cause a credit crunch. A positive side-effect is that the buffer might potentially help curb lending in periods of excessive credit growth.

Activating the countercyclical capital buffer implies higher capital requirements for the banks. When the latter adapt to higher capital requirements, the funding cost might rise because capital is usually a more expensive form of funding than loans. In this context, it should be noted that a countercyclical buffer rate of 1 per cent accounts for just under 2 per cent of the combined total capital need.<sup>21</sup>

It is difficult to evaluate the effects of the capital rules on lending volumes and interest rates for households and non-financial corporations. This is due to the uncertainty surrounding the effect on the total capital and funding cost of the credit firms – a higher share of equity can reduce the cost of other funding – and to credit firms making business decisions on grounds other than regulations alone. There is reason to believe that higher capital requirements affect total funding costs in different ways depending on the state of the capital market and the capital strength of the firms to start with. In cases where regulation implies increased costs for the credit firms, it can affect households and non-financial corporations in the form of lower lending volumes or higher lending rates, which can in turn lead to reduced consumption and investment.

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<sup>21</sup> FI (2014), *Capital requirements for Swedish banks*. Published on fi.se on 10 September 2014, FI ref. 14-6258.

Finansinspektionen conducts ongoing work on analysing lending in society and credit terms for corporations and households, as well as developments in setting interest rates and the various components of the latter. This includes studying the effects of the capital adequacy rules for SMEs. This work is reported in, for example, FI's half-yearly stability report and the annual mortgage survey.

### **3.4 Consequences for Finansinspektionen**

As the authority responsible for setting the countercyclical capital buffer, Finansinspektionen shall, according to the buffer act, on a quarterly basis assess and set the countercyclical buffer rate for Sweden. This will involve a lot of work in terms of monitoring and analysing a series of different relevant indicators, calculating the credit gap indicator and otherwise making an overall assessment based on both qualitative and quantitative rationales when deciding on the buffer rate. This work will be conducted within the framework of Finansinspektionen's ongoing work on capital requirements for Swedish financial institutions and financial stability.

In addition, there will also be further work in connection with Finansinspektionen's obligation, in accordance with the buffer act, to notify ESRB of the quarterly set countercyclical buffer rate. In addition, Finansinspektionen shall, in cases where a designated authority or relevant third-country authority has set a countercyclical buffer rate exceeding 2.5 per cent of the total risk-weighted exposure amount, assess and decide on whether or not to approve that buffer rate for the nationally authorised institutions' calculation of their institution-specific countercyclical capital buffers. These tasks will also be conducted within the framework of Finansinspektionen's ongoing work and using existing resources.

## Appendix 1

### Description of the credit measure

The Basel Committee believes that as broad a measure as possible for aggregate lending should be used to calculate the credit gap. Lending to the private sector can be divided into loans to households and corporations, respectively. Household lending consists primarily of traditional bank loans and other loans from monetary financial institutions (MFI). In addition to such loans, which cover around 90 per cent of the total debt of households, the loan stock also consists to a certain extent of loans granted from creditors other than MFIs. Since this type of loans covers a relatively small share of household debt, and the individual loans are also generally smaller in size with a shorter maturity than traditional bank loans, they are less relevant to studying the build-up of systemic risks. Such types of loan have therefore been excluded from the credit measure.

In terms of lending to the corporate sector, there are two identifiable sources of credit. One of them, like for households, is traditional bank loans through MFIs. The other source consists of interest-bearing securities traded on the market, i.e. through issuing certificates and corporate bonds. The same limitation for loans other than those issued through MFIs has been done for the corporate sector. The credit measure for total lending to the private sector in Sweden is thus defined as:

$$Credit_t^{Nominal} = Credit_{MFI_t}^{HH} + Credit_{MFI_t}^{NFC} + Market_t^{NFC}$$

Where HH = households, including non-profit organisations, NFC = non-financial corporations and MFI = monetary financial institutions.

The time series is in nominal terms on a quarterly frequency and starts in the fourth quarter of 1980. The statistics used to calculate the credit measure are issued by The Financial Accounts according to Statistics Sweden, and Financial Markets Statistics according to the Riksbank. The measure thus includes all lending to corporations and households issued by MFIs, and the corporations' total market financing defined as the value of all outstanding corporate bonds and certificates traded on the fixed-income market.

## Appendix 2

### Calculation of the credit gap

Swedish aggregate credit in relation to GDP is derived as:

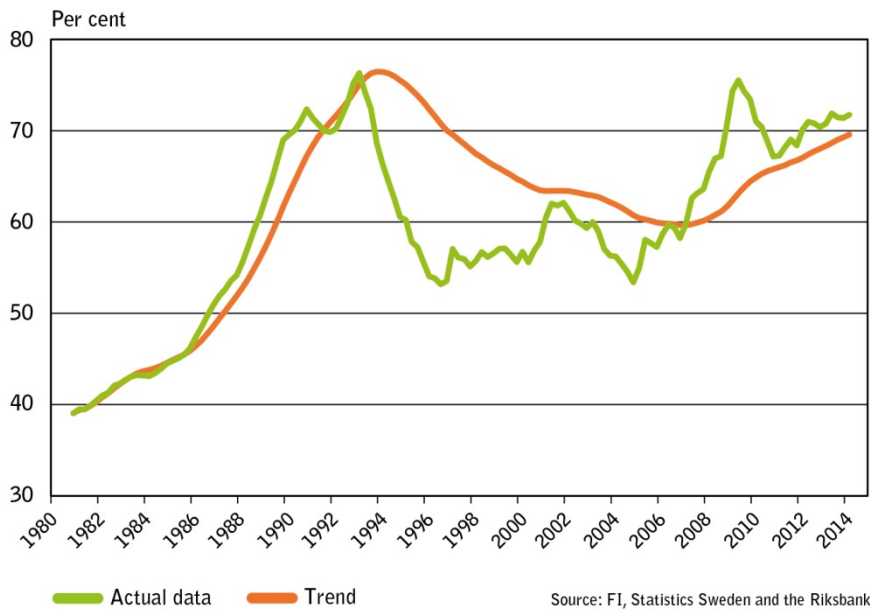
$$\frac{Credit_t^{Nominal}}{\sum_{j=(t-3)}^t GDP_j^{Nominal}} * 100$$

GDP is summed up over four quarters to calculate the value of production in Sweden in the past year. The credit measure is a stock variable and consists of total private lending in Sweden. The measure thus comprises all lending to corporations and households granted through MFIs and the total market funding of the firms. The credit measure is reported as the mean of total lending for each period, with the exception of market funding, which is reported as the total value of outstanding issued bonds and certificates at the close of quarters.

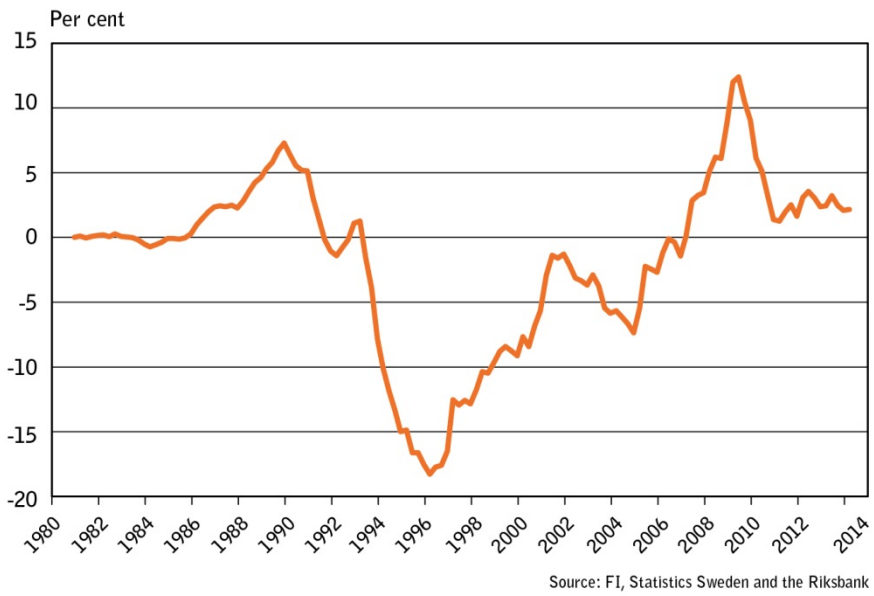
For the ratio given above, a trend is then calculated using a one-sided HP filter. The trend is subsequently subtracted from actual data to obtain the credit gap. When the credit gap has been calculated, the level of the countercyclical capital buffer stands in relation to the gap according to the linear function shown in diagram 1.

The credit gap for the household and corporate sectors, respectively, as shown below, is derived in the same way as the total credit gap, except for the calculations being made using household and corporate credits, respectively.

**B 2.1 Credit to corporations in relation to GDP, actual data and trend**

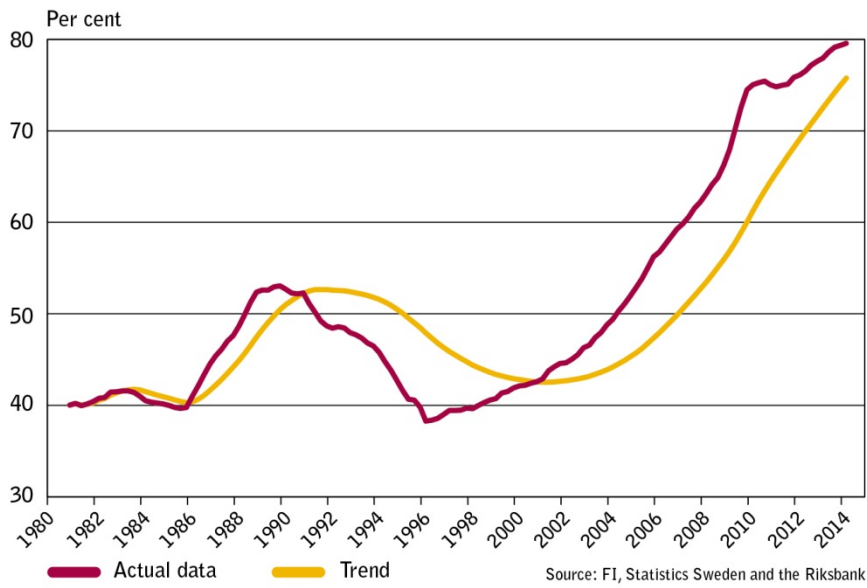


**B 2.2 Credit gap corporations**

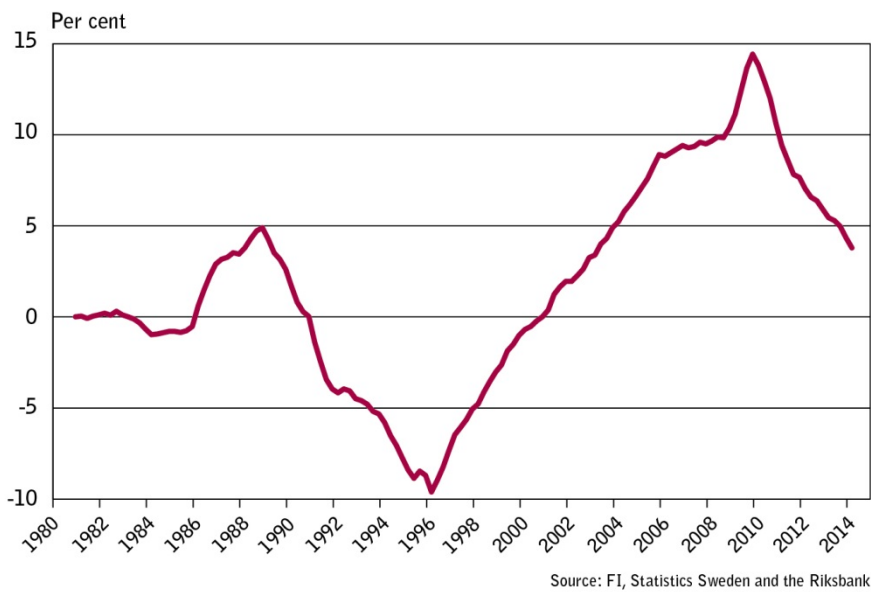




**B 2.3 Credit to households in relation to GDP, actual data and trend**

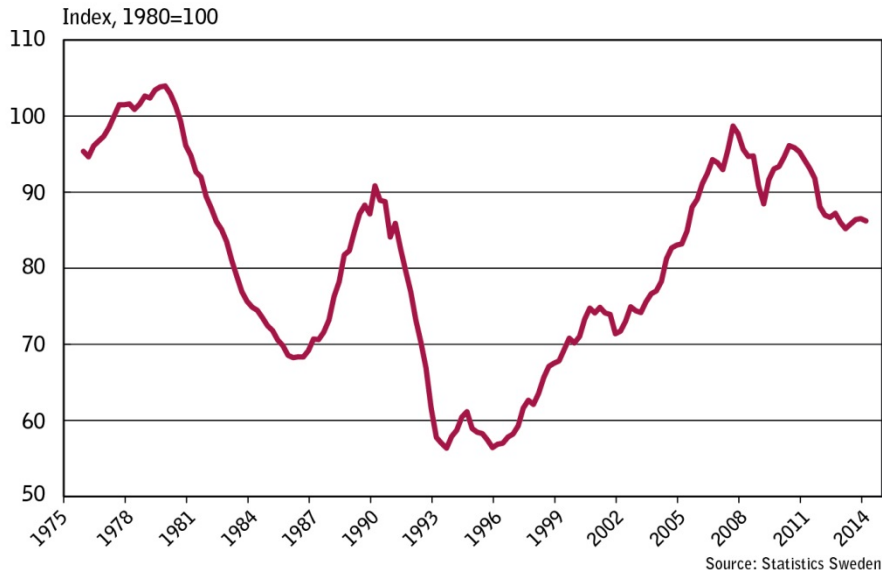


**B 2.4 Credit gap households**

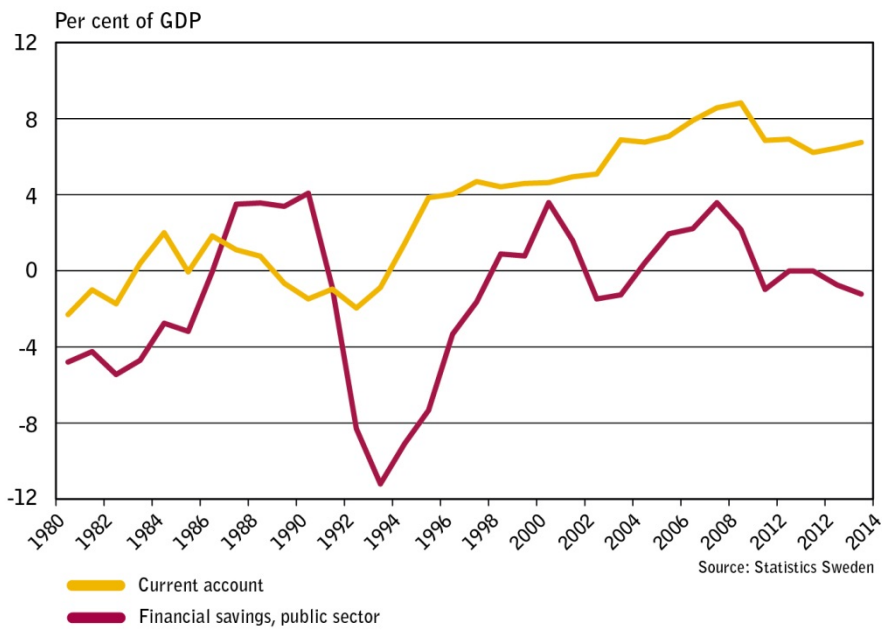


### Appendix 3

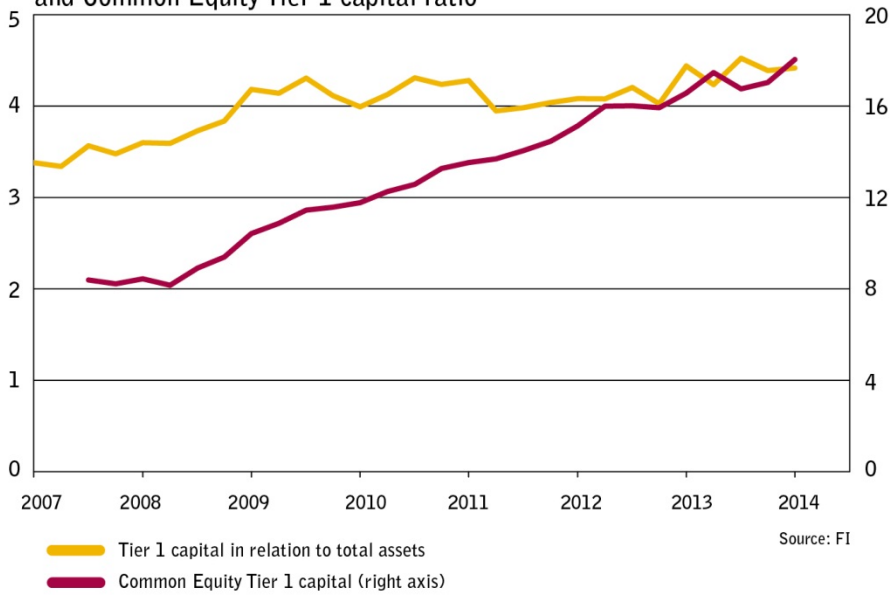
#### B 3.1 House prices in relation to disposable income



#### B 3.2 Current account and financial savings in the public sector

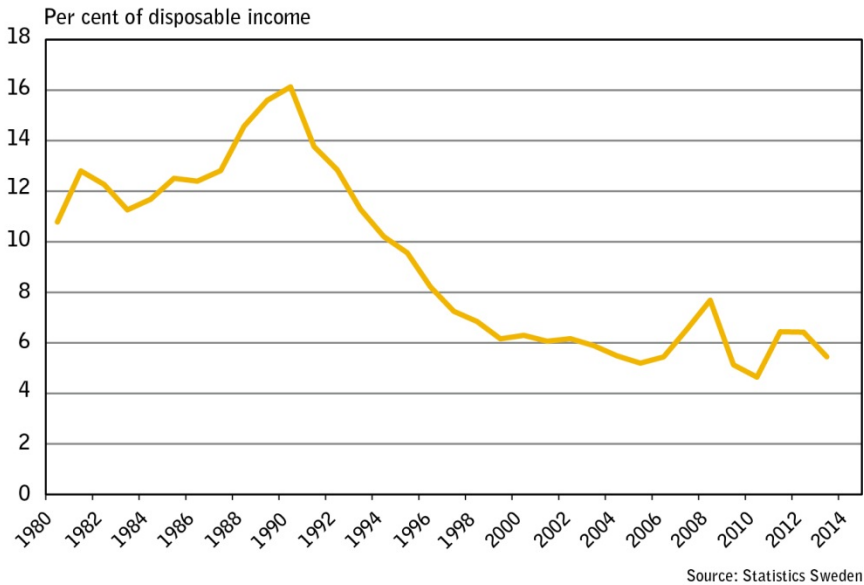


**B 3.3 Tier 1 capital in relation to total assets and Common Equity Tier 1 capital ratio**



Note. The measures are an average of the four major banks. Before the third quarter of 2008, the common equity Tier 1 capital ratio is an average for Handelsbanken, SEB and Swedbank.

**B 3.4 Interest rate ratio of households**



### B 3.5 Real equity prices



Note: Real equity prices have been calculated by deflating the OMX by CPIF.

Source: Statistics Sweden and Reuters Ecowin