

DECISION MEMORANDUM



FI Ref. 15-7062

**Finansinspektionen**  
Box 7821  
SE-103 97 Stockholm  
[Brunnsgatan 3]  
Tel +46 8 787 80 00  
Fax +46 8 24 13 35  
finansinspektionen@fi.se  
www.fi.se

## **Amendment to regulations regarding the countercyclical buffer rate**

### **Summary**

Finansinspektionen decides that the countercyclical capital buffer for Sweden shall be increased and the buffer rate shall be set at 1.5 per cent given the present economic conditions. The countercyclical buffer guide, which forms part of setting the buffer rate, shall be set at 1.5 per cent. The stated countercyclical buffer rate shall be applied as of 27 June 2016.

Finansinspektionen shall, in accordance with Chapter 7, section 1 of the Capital Buffers Act (2014:966), set a countercyclical buffer guide and countercyclical buffer rate each quarter. 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 managers licensed to conduct discretionary portfolio management when they calculate the firm-specific countercyclical capital buffer.

Finansinspektionen finds that the systemic risks linked to financial imbalances have increased somewhat, both compared with September 2014 when the buffer was set at 1 per cent, and compared with the first quarter of 2015 when Finansinspektionen decided to leave the buffer unchanged. Credit growth in Sweden has accelerated and lending to non-financial corporations has recovered to normal levels. At the same time, household indebtedness is high and largely consists of mortgages. The upward trend in household lending persists, and is also expected to continue to be affected by the rapidly rising house prices. There is also a risk of the absence of an amortisation requirement potentially contributing to somewhat higher credit growth and higher house prices.

On the whole, Finansinspektionen finds reason to increase the countercyclical capital buffer in order to strengthen resilience in the financial system, and hence improve its possibilities of managing potential problems. Finansinspektionen therefore decides that the countercyclical buffer rate shall be set at 1.5 per cent.

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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 of the Buffer Act, Finansinspektionen shall set a countercyclical buffer guide and a countercyclical buffer rate each quarter. 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 firm-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 a matter of setting standards and shall therefore be issued in the form of regulations.

The firms 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, “bank” is used as a collective term for these firms.

### 1.1 Objective of the regulation

The purpose of the countercyclical capital buffer is to strengthen the resilience of banks and ensure that the banking system as a whole has sufficient capital to sustain the flow of credit to households and corporations in situations when shocks to the financial system could cause a credit crunch. The countercyclical capital buffer is a time-varying capital requirement. This means that the buffer shall be built up when there is a risk of financial imbalances, and hence systemic risks, growing. In a subsequent recession or in the event of the banks incurring major losses, the latter can tighten lending, which can amplify the economic downturn. In such a situation, the buffer requirement can be reduced to counteract a credit crunch.

### 1.2 Current and forthcoming regulations

On 25 June 2014, Swedish Parliament decided on new statutory provisions regarding capital adequacy rules, including the Buffer Act. The Buffer Act came into effect on 2 August 2014. Finansinspektionen decided on 8 September 2014 on new regulations regarding the countercyclical buffer rate:

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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.

Finansinspektionen's regulations (FFFS 2014:33) regarding the countercyclical buffer rate.<sup>2</sup> These regulations meant that the countercyclical capital buffer for Sweden was activated. According to the regulations, the countercyclical buffer rate shall be 1 per cent and be applied as of 13 September 2015. On 16 March 2015 Finansinspektionen made its latest decision<sup>3</sup> in accordance with the quarterly procedure<sup>4</sup>. Through the decision, it was determined that the buffer rate of 1 per cent continues to apply.

### 1.3 Alternative to regulation

When preparing the regulations regarding the countercyclical buffer rate, Finansinspektionen has observed EU law and the rules of the Capital Requirements Directive. Sweden is obliged to implement the rules of the Capital Requirements Directive regarding e.g. countercyclical capital buffers. These rules are implemented in Swedish law primarily through Chapter 7, sections 1–3 of the Buffer Act. According to Chapter 7, section 1 of the Buffer Act, Finansinspektionen shall set a countercyclical buffer guide and a countercyclical buffer rate each quarter. With due consideration for the Swedish judicial system, this entails 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 Preparation

According to the quarterly procedure for determining the countercyclical buffer rate, new regulations will be issued when Finansinspektionen assesses that the rate decided needs to be changed. Ahead of such a change, a proposal for regulations shall be submitted for consultation. If Finansinspektionen considers that there is no need to change the rate, the Board of Directors of Finansinspektionen will decide on this and the decision will be published on Finansinspektionen's website. The Board of Directors will also, ahead of each new decision, determine the focus of the work to prepare the next decision. This too is announced on Finansinspektionen's website.

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<sup>2</sup> FI (2014), *Regulations regarding the countercyclical buffer rate*. Published on fi.se on 10 September 2014, FI ref. 14-7010.

<sup>3</sup> FI (2015), *Decision regarding the countercyclical buffer rate*. Published on fi.se on 17 March 2015, FI ref. 15-3226.

<sup>4</sup> For a description of the quarterly procedure for setting the countercyclical buffer rate, see FI (2014), *Regulations regarding the countercyclical buffer rate* Published on fi.se on 10 September 2014, FI ref. 14-7010.

On 20 April 2015, the Board of Finansinspektionen expressed that work shall continue with the orientation that the countercyclical capital buffer might potentially change and that a regulatory project shall thus be commenced. By reason thereof, Finansinspektionen, based on the quantitative and qualitative analysis, made an assessment of whether there are grounds that motivate an increase of the buffer rate, or if the rate should be kept unchanged. On 26 May 2015, Finansinspektionen submitted a proposal to amend regulations regarding the countercyclical buffer rate together with a consultation memorandum. The analysis in this decision memorandum is based on information available until 15 June 2015.

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 Riksbank, the Swedish National Debt Office, the Swedish Better Regulation Council and The Swedish National Board of Housing, Building and Planning. A number of other consulted bodies, such as Kommuninvest, the Swedish Competition Authority and The Swedish Accounting Standards Board have notified that they do not have any feedback on the proposal. Finansinspektionen has taken the feedback of the consulted bodies into consideration.

*The Swedish Bankers' Association* has expressed views regarding the preparation of the matter. Amongst other factors, the Bankers' Association finds that a consultation period of ten working days is too short, even though it understands that the quarterly process of setting the buffer rate may pose a challenge to Finansinspektionen in terms of time restraints. In addition, the Bankers' Association finds that it should not have taken just over one month from the Board of Finansinspektionen finding reason to consider increasing the buffer, to its proposal being submitted for consultation. Finally, the Bankers' Association finds it difficult to see how Finansinspektionen, in as short a period as nine working days, can take into consideration the feedback of the consulted bodies and make a decision in the matter.

Finansinspektionen understands that a consultation period of ten working days feels short. The order of the quarterly review of the countercyclical capital buffer determined in the Capital Requirements Directive and in the Buffer Act imposes specific requirements on Finansinspektionen as decision-maker. This means that work on amendment proposals must take place in a way that is different to what usually applies. Finansinspektionen has chosen to fully follow a model for consultation processing of thoroughly motivated proposals. In light thereof, Finansinspektionen is in no doubt that the Bankers' Association and other consulted bodies, well aware as they are of how the decisions regarding the countercyclical capital buffer must be prepared, are prepared to give constructive feedback in order to provide Finansinspektionen with a solid basis for taking a position.

## 2 Reasoning and considerations

Finansinspektionen's proposal and the considerations made with respect to the regulations regarding the countercyclical buffer rate are described below.

In this section Finansinspektionen describes its position regarding the size of the countercyclical capital buffer rate in Sweden. The chapter describes the considerations made about the size of the buffer rate given the economic and financial conditions currently prevailing. Here, Finansinspektionen also describes and addresses the feedback of the consulted bodies.

### 2.1 Background

The purpose of the countercyclical capital buffer is to strengthen the resilience of banks and ensure that the banking system as a whole has sufficient capital to sustain the flow of credit to households and corporations in situations when shocks to the financial system could cause a credit crunch. The countercyclical capital buffer shall be built up when there is a risk of financial imbalances, and hence systemic risks, growing. In a subsequent recession or in the event of the banks incurring major losses, the latter can tighten lending, which can amplify the economic downturn. In such a situation, the buffer requirement can be reduced to counteract a credit crunch.

Finansinspektionen sets the countercyclical buffer rate for Sweden by means of a qualitative assessment that takes quantitative factors into consideration. The *countercyclical buffer guide* is an important, but not decisive, basis for this assessment. Finansinspektionen also considers other quantitative variables that are relevant for assessing the cyclical systemic risks.

### 2.2 The countercyclical buffer guide

The buffer guide is the point of departure for Finansinspektionen's analysis and assessment of the countercyclical buffer rate in Sweden. There is, however, no mechanical link between the buffer guide and the level of the countercyclical buffer. Decisions on the countercyclical buffer rate are based on both quantitative and qualitative assessments of the sustainability of the credit development and the level of systemic risks. Therefore, Finansinspektionen also takes into consideration other relevant variables that can signal the build-up or slowdown of cyclical systemic risks, and supplements the analysis with its own qualitative assessments.

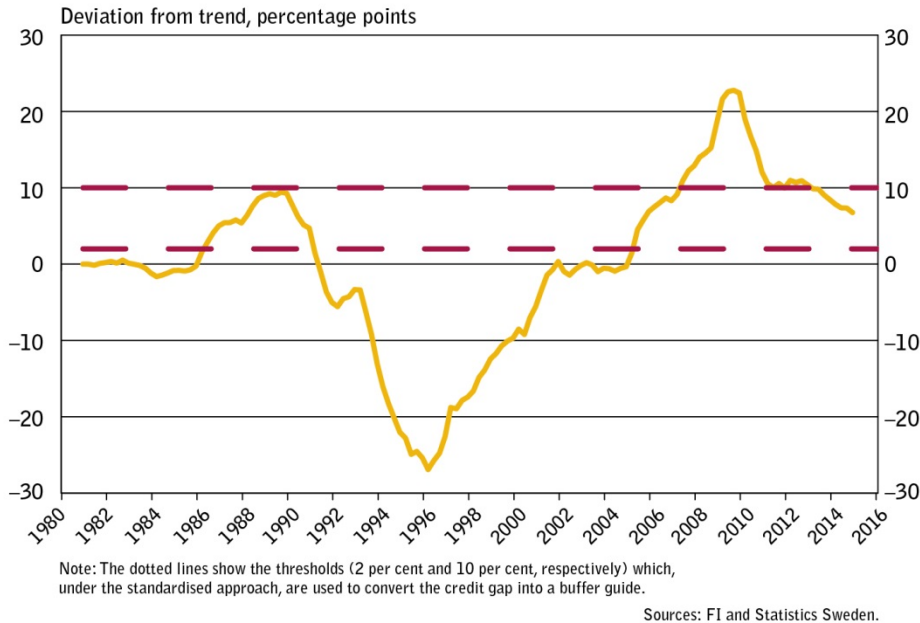
Finansinspektionen calculates the countercyclical buffer guide in accordance with the Basel Committee's standardised approach<sup>5</sup>, which is based on the credit gap, i.e. how much total household and corporate lending in relation to

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<sup>5</sup> For more information about the standardised approach, see FI (2014), *Regulations regarding the countercyclical buffer rate*. Published on fi.se on 10 September 2014, FI ref. 14-7010.

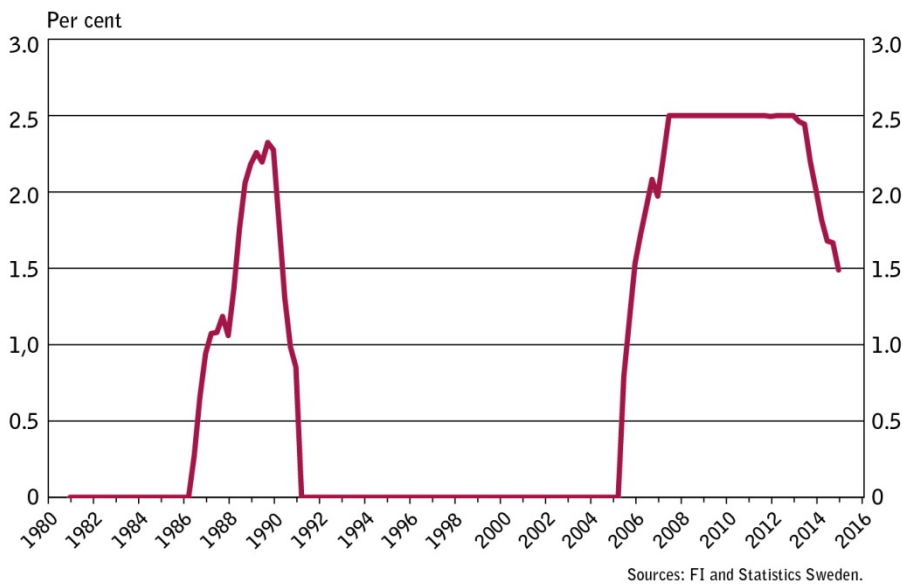
gross domestic product (GDP) deviates from its long-term trend. According to the standardised approach, the credit gap was 6.8 per cent in the fourth quarter of 2014, which is the latest available outcome (see diagram 1).

**1 Credit gap according to the standardised approach**



The credit gap is converted into a buffer guide according to a quantitative rule that specifies how the credit gap and buffer guide are to stand in relation to each other. A credit gap of 6.8 per cent means that the countercyclical buffer guide for Sweden is 1.5 per cent (see diagram 2).

**2 Buffer level according to standardised approach**



## 2.3 Other quantitative indicators

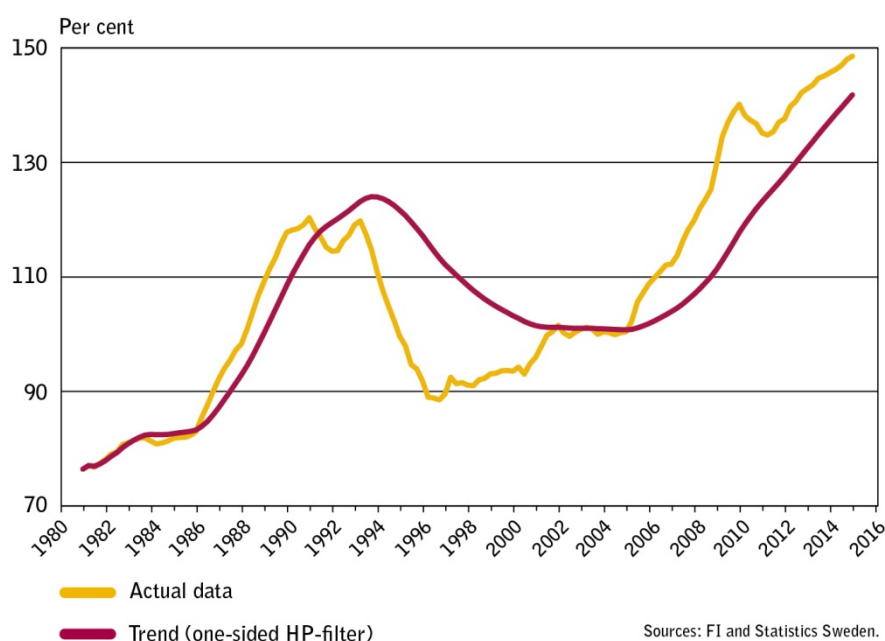
Finansinspektionen has chosen to monitor a number of indicators that, in addition to the credit gap, are considered to be relevant to Sweden when setting the countercyclical buffer rate. These include various measures of the development in household and corporate lending, house prices in relation to disposable income, current account and financial savings in the public sector as a share of GDP, bank capital levels, the interest-to-income ratio of households, and developments in real equity prices.<sup>6</sup>

### 2.3.1 Credit growth is on the rise

The point of departure for Finansinspektionen's assessment of cyclical systemic risks is the development in lending to the non-financial sector over time, both as a whole<sup>7</sup> and in its parts (for example credit to households and corporations, respectively). The credit development can then be related to other variables such as GDP or the household income development, in order to assess whether the trend appears reasonable or whether it signals that imbalances are being built up in the financial system.

Household and corporate lending continues to increase in Sweden. In addition, aggregate lending is increasing faster than nominal GDP, and has done so since 2011 (see diagram 3).

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



<sup>6</sup> Appendix 1 provides diagrams of the development for these indicators.

<sup>7</sup> For Sweden, the measure of total credit to the private sector covers all corporate and household lending issued through monetary financial institutions (MFI) and the total market financing of corporations. The market financing of corporations has been defined as the value of all outstanding corporate bonds and certificates traded on the fixed-income market.



In the fourth quarter of 2014 total lending grew 5.6 year-on-year (see table 1), which can be compared with a nominal GDP growth of 3.5 per cent in the same quarter.

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

Annual percentage change

	Households (MFI)	Corporations (MFI)	Corporations (market)	Corporations (MFI+market)	Total credit
2013 kv 4	4.9	1.3	11.7	4.0	4.5
2014 kv 1	4.9	0.8	14.3	4.4	4.6
2014 kv 2	5.1	2.3	11.3	4.7	4.9
2014 kv 3	5.4	3.0	13.3	5.8	5.6
2014 kv 4	5.7	3.5	10.7	5.4	5.6

Note: MFI refer to Swedish financial institutions.

Source: Statistics Sweden.

Lending from monetary financial institutions (MFI) to households shows a sustained upward trend and the growth rate was 5.7 per cent in the fourth quarter of 2014. Monthly statistics from Statistics Sweden also show that the growth rate has gradually increased since 2013. In March 2015, the annual growth rate for household lending had increased to 6.4 per cent (see table 2).

### 2 Growth rates in MFI-lending to households and corporations

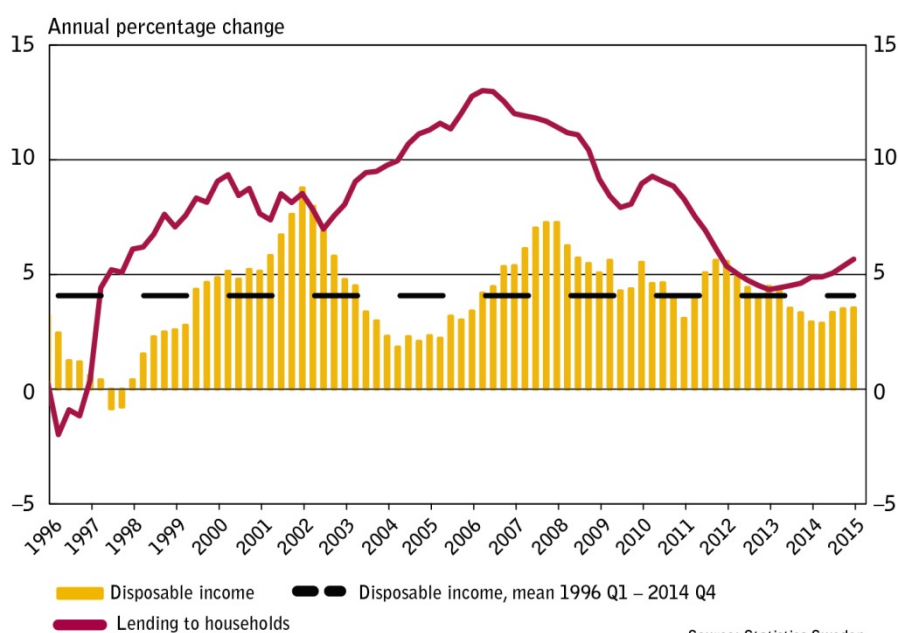
Annual percentage change

2015	Households, total	Households, housing	Corporations
January	6.1	6.4	4.4
February	6.2	6.6	5.0
March	6.4	6.8	4.7

Source: Statistics Sweden.

Household indebtedness is also increasing in relation to households' disposable income, which increased 3.6 per cent in the fourth quarter of 2014 (see diagram 4).

#### 4 Growth rate in lending to households and nominal disposable income



One reason for the acceleration in household lending is rapidly rising house prices. The ratio between house prices and disposable income increased somewhat further in the fourth quarter of 2014 compared with the preceding quarter (see diagram B 1.1). Statistics from Statistics Sweden show that the prices of single-family dwellings rose 8 per cent in the three-month period February – April 2015 compared with the same period a year before.<sup>8</sup> Since just over 80 per cent of household lending consists of mortgages, while at the same time house prices continue to rise rapidly, it is probable that household lending will continue to grow faster in the near future.

Rapidly rising house prices and increasing household indebtedness are an indication that vulnerabilities are being built up. At the same time, household mortgage rates have gradually declined, both for short and long fixed-interest periods. This has a direct link to households' interest-to-income ratio<sup>9</sup>, which remains very low indeed. Currently, interest expense, after tax deduction, amounts to 3.2 per cent of disposable income (see diagram B 1.4). In addition, Finansinspektionen's stress tests show that households have considerable resilience to higher interest rates, loss of income and declining house prices.<sup>10</sup>

<sup>8</sup> Information from Mäklarstatistik show that the price of tenant-owned apartments in Sweden rose 6 per cent in the latest three-month period of February – April 2015, while the price of detached houses increased by 5 per cent. Year-on-year, the price change is 13 per cent for tenant-owned apartments and 12 per cent for detached houses. See <http://maklarstatistik.se/pressmeddelande/pm-2015-05-13.aspx>.

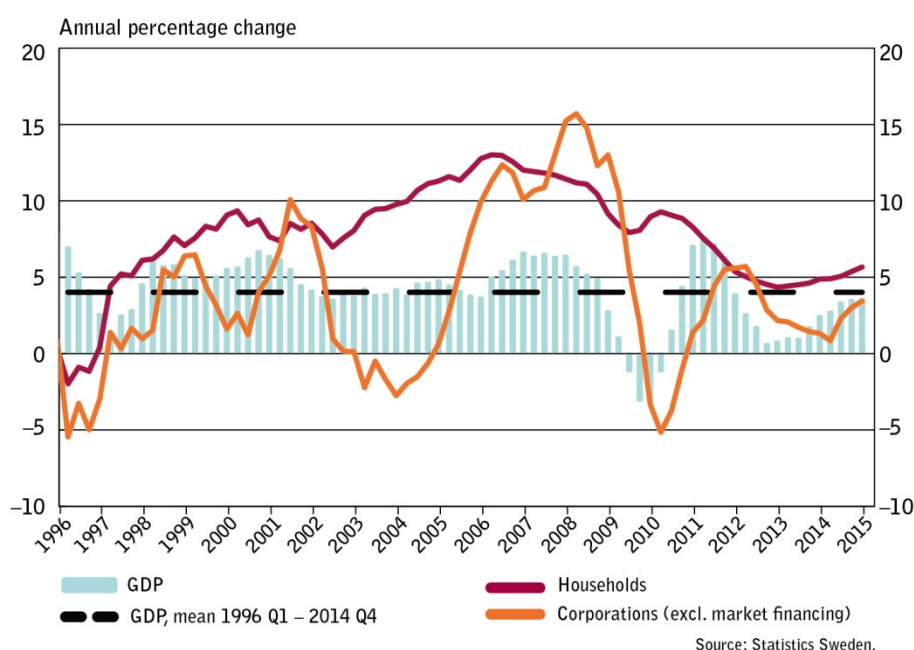
<sup>9</sup> The interest-to-income rate ratio shows how large a share of households' disposable income is spent on interest expense; that is, households' debt servicing expenses.

<sup>10</sup> FI (2015), *The Swedish mortgage market 2015*. Published on fi.se on 14 April 2015, FI ref. 14-8731.

The resilience of new borrowers was much higher in 2014 than 2013, when an increase to the interest rate of 5 percentage points entailed a deficit for double the number of households. On the whole, Finansinspektionen finds that Swedish households are considerably resilient, and the risks of major credit losses linked to household indebtedness remain low.

Lending by MFIs to non-financial corporations continues to show signs of recovery and increased by 3.5 per cent in the fourth quarter of 2014, which was in line with nominal GDP growth (see diagram 5). The latest monthly figures from Statistics Sweden show that the corporate lending of MFIs continues to accelerate. Growth amounted to 4.7 per cent in March 2015 (see table 2).

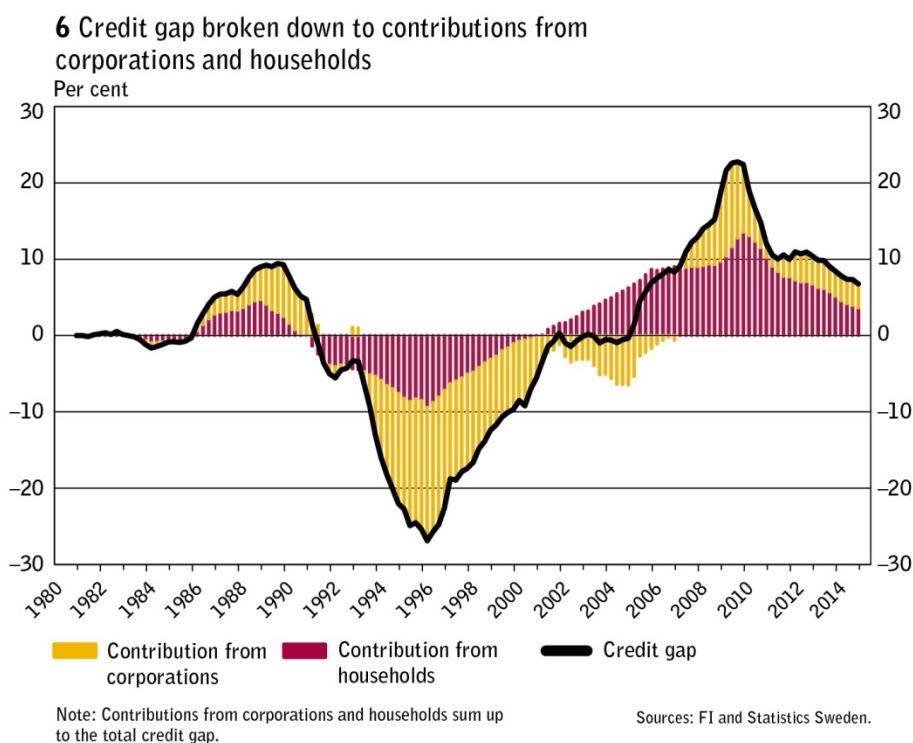
### 5 Growth rate in MFI-lending to households and corporations and nominal GDP growth



Just like before, market financing continues to be an increasingly important source of financing for non-financial corporations, even though the growth rate slowed down to 10.7 per cent for the fourth quarter of 2014. On the whole, therefore, total corporate lending – which includes both lending from MFIs and through market financing – grew somewhat slower in the fourth quarter than in the preceding quarter.

Yet, corporate lending grew 5.4 per cent, which is faster than nominal GDP growth. The increase in total corporate lending that occurred in 2014 probably reflects the strong upswing in investment that took place during the year. The Swedish National Institute of Economic Research assesses that investment growth in 2015 and 2016 will slow down. On that basis, it is probable that growth in corporate lending will not continue to increase at the same rate as in 2014.

Credit growth with respect to the household sector has long been the driving force behind total lending growth in Sweden. Its contribution to the total credit gap is still greater than that of growth in corporate lending. However, due to the acceleration in corporate lending growth in recent quarters, the latter is contributing to an increasing part of the total credit gap (see diagram 6).



In summary, the figures for the fourth quarter of 2014 show a more rapid annual growth rate of household lending, but a somewhat lower annual growth rate for corporate lending. Because of this, the growth rate in total credit to the private sector remained unchanged at 5.6 per cent (see table 1). At the same time, the latest statistics show that MFIs' lending to both households and corporations is on the rise. In particular, household debt risks accelerating even more ahead in light of the sustained increase in house prices.

### 2.3.2 Other indicators do no point to an appreciable increase in systemic risks

A review of the banks' situation in the first quarter of 2015 shows that they continue to have sound profitability and are well-capitalised (see diagram B 1.3).<sup>11</sup> The resilience of the Swedish banking sector thus remains high. A substantial current account surplus and – compared with many European countries – stable public finances, also imply relatively small risks (see diagram B 1.2).

<sup>11</sup> See also FI (2015), *The Swedish banks' capital requirements, first quarter 2015* Published on fi.se on 22 May 2015, FI ref. 15-7395.

Real equity prices have risen relatively sharply since the financial crisis, particularly since mid-2012 (diagram B 1.5). This could be interpreted as the equity market being overvalued and that there is a heightened risk of the market incorrectly pricing risks. However, the 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. Finansinspektionen is of the opinion that at present the trend is not in itself unreasonable, particularly in light of the low interest rates.

## 2.4 The countercyclical buffer rate for Sweden

**Finansinspektionen's position:** The countercyclical capital buffer for Sweden shall be increased and the buffer rate shall be set at 1.5 per cent given the present economic conditions. The countercyclical buffer guide for Sweden, which forms part of setting the buffer rate, is set at 1.5 per cent.

**Consultation memorandum:** The proposal had the same content.

**Consulted bodies:** *The Riksbank* welcomes an increase in the countercyclical buffer rate and shares Finansinspektionen's view that systemic risks have also increased recently. However, the Riksbank finds that an increase in systemic risks over a long period of time in Sweden, combined with the latest indications of a more rapid build-up of risks, motivates a substantial increase in the countercyclical buffer rate. For this reason, the Riksbank finds that the buffer rate should be set at 2.5 per cent instead of the proposed 1.5 per cent.

Furthermore, the Riksbank finds that the recent acceleration in the build-up of risk also motivates a shorter implementation period than that proposed by Finansinspektionen. According to the Riksbank, the countercyclical capital buffer should already have been raised earlier. When, in addition, the risks are rising at an increasing rate, the situation is sufficiently exceptional to motivate a faster implementation than the usual twelve months. Hence, in the Riksbank's opinion, the higher buffer rate should apply as early as on 28 December, i.e. in six months' instead of twelve months' time.

Furthermore, the Riksbank finds it necessary to improve without delay the resilience of banks in light of e.g. the expansive monetary policy and rapidly rising household indebtedness. The increase in capital that would ensue from the higher countercyclical capital requirement proposed by Finansinspektionen is, in the Riksbank's opinion, relatively small, particularly compared with the banks' common equity Tier 1 capital or total assets. Furthermore, the Riksbank emphasises that the higher buffer level is motivated despite the standardised approach for calculating the size of the buffer indicating a reduction. Because the standardised approach has a number of deficiencies, the Riksbank finds that the reduction in the buffer guide provides a misleading representation of the risks.

The Riksbank is also of the opinion that the interest rate increases, to which an increase in the countercyclical capital buffer could give rise, are small and that the effect on economic activity in the near future will thus be slight. The Swedish banking sector currently has sound earnings capacity, which further limits the potential negative effects which the countercyclical capital buffer could have on economic activity in the short term.

Furthermore, the Riksbank is of the opinion that other measures are needed to bolster the resilience of banks, such as by means of introducing a minimum leverage ratio requirement, or increasing the risk weight floor for mortgages. In addition to measures to strengthen the banks' resilience, the Riksbank finds that measures are needed to reduce the risks in the household sector.

*The Swedish Bankers' Association* opposes Finansinspektionen's proposal to set the countercyclical buffer rate at 1.5 per cent. The Bankers' Association perceives that Finansinspektionen's primary reason for the proposal to increase the buffer to 1.5 per cent is that the authority cannot currently implement the amortisation requirement in the desired manner. Although the Bankers' Association is positive on a strengthened amortisation culture, it finds that the countercyclical buffer has very negligible effects on lending for homes. However, the Bankers' Association finds that a higher buffer requirement will affect the real economy, mainly because it can hamper 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. According to the Bankers' Association, an increase in the buffer is also in contrast to the Riksbank's rate cuts, which aim to stimulate the Swedish economy.

Furthermore, the Bankers' Association expresses that Swedish banks are currently very well-capitalised and that resilience in the Swedish banking sector remains high. The risk of banks not having sufficient capital to withstand a systemic crisis is thus low and declining. The Bankers' Association also refers to the fact that the increase in the risk weight floor for mortgages to 25 per cent, implemented by Finansinspektionen in September 2014, reduces the need for a high countercyclical capital buffer. If the higher countercyclical buffer is introduced, the Bankers' Association assumes that Finansinspektionen will review the level as soon as the government issues its decision regarding amortisation requirements.

*The Swedish Savings Banks Association* finds that the proposal to increase the countercyclical buffer rate should be withdrawn because it rests on the wrong grounds. According to the Association, the most crucial reason for the proposal to increase the buffer rate appears to be that the proposed amortisation requirement will not be introduced in August 2015. The Association notes that the purpose of the countercyclical capital buffer is to strengthen the resilience of the banks, while the purpose of the amortisation requirement is to curb credit growth and the house price increases for the household sector. According to the Association, an increase in the buffer entails a tightening in lending in general

and to the corporate sector in particular. Because an increase in the countercyclical buffer does not achieve the effect that was the purpose of the amortisation requirement, the Association proposes that the proposal regarding an increased buffer rate be withdrawn.

*The Swedish National Debt Office* shares Finansinspektionen's view that the absence of the amortisation requirement, together with other developments, has contributed in systemic risks rising somewhat, but that the increase appears limited thus far. The overall picture provided by the indicators does not show that Sweden is in the advanced stages of a clear upswing, either in the financial or real cycle. Furthermore, the Debt Office is of the opinion that the current change in lending appears moderate, in light of the major fluctuations in e.g. lending over a cycle. In light of the fact that the proposed measure is to reflect cyclical fluctuations, the Debt Office is therefore doubtful as to whether the countercyclical capital buffer needs to be raised.

At the same time, the Debt Office expresses that an increase to the countercyclical buffer could be justified ahead if credit growth continues to increase, for instance to such an extent that the credit gap clearly grows and becomes more positive. Such an increase in debt is, According to the Debt Office, far from improbable, partly due to increased home construction of, for instance, tenant-owned apartments.

*The Association of Swedish Finance Houses* finds that the set buffer rate of 1 per cent ought not to be increased. The Association finds 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 with reasonably limited growth in 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 potentially be taken to control mortgage lending.

*The Swedish National Board of Housing, Building and Planning (NBHBP)* supports increasing the buffer rate from 1 to 1.5 per cent. This is in light of the fact that present, still-rapid credit growth is based on already substantial systemic risk. The lack of operational macroprudential tools at present makes an increased capital buffer, with rapidly expanding credit growth, all the more pressing.

According to the NBHBP, particularly the high mortgage debts of households, combined with high house prices, give cause for concern. Seen in relation to disposable income, debts have never been as high as they are today. Thus, household debt poses a substantial systemic risk. The flip side of the coin consists of high house prices. Therefore, the NBHBP finds that greater buffers increase the banks' possibilities of managing a future crisis on the housing market and increase the possibilities of limiting the negative effects on the economy.

Although Swedish banks have increased their common equity Tier 1 capital ratios and liquidity coverage ratios substantially in recent years, the NBHBP finds that the banks, based on the leverage ratio, are not well-capitalised. In light thereof, the NBHBP therefore finds it all the more important to have a greater proportion of equity in the balance sheet. Hence, the authority is of the opinion that the countercyclical buffer rate needs to be increased, particularly in light of the proposed amortisation requirement not being introduced in August 2015.

*The Swedish Competition Authority, Kommuninvest and The Swedish Accounting Standards Board* have no views on the proposal to amend the countercyclical buffer rate.

**Finansinspektionen's grounds:** The purpose of the countercyclical capital buffer is to strengthen the banks' resilience in periods of build-up of systemic risks. By building up capital buffers, the banking system can be better equipped to face potential disruptions and a sagging economy. Thus, banks can continue to provide credit to households and corporations. The buffer shall be built up when credit growth is excessively high and risks building up systemic risks. In a recession or in the event of major losses for the banks, the buffer requirement may be reduced to counteract tighter lending amplifying the economic downturn.

The indicators described above suggest that credit growth is currently accelerating, but is not dramatically high. Total lending to the private non-financial sector continued to increase in the fourth quarter of 2014, although the growth rate has slowed down and is at the same level as in the preceding quarter. Monthly statistics and a sustained increase in house prices imply, however, that credit growth may increase in the next few quarters.

Furthermore, the analysis shows that corporate lending from MFIs has recovered. Growth is on a par with nominal GDP growth – a development that is deemed reasonable. In addition, corporations continue to raise financing via the market to a growing extent. While corporate market funding shows a high growth rate, it is nevertheless occurring from relatively low levels and the year-on-year rate also dropped in the fourth quarter of 2014. Because total corporate lending has, for a relatively long time, been at a low level, Finansinspektionen does not consider this development to be problematic and there are signs that corporate lending will perhaps not further accelerate ahead. Finansinspektionen therefore finds that the growth in lending to the corporate sector is not excessive, but not weak either.

At the same time, household indebtedness is high and the upward trend in household lending persists. In addition, lending to the household sector continues to grow faster than both nominal GDP and disposable income. One reason for this is ever-increasing house prices. Mortgages account for just over 80 per cent of total household lending. The annual growth rate for mortgages



was 6.8 per cent in March 2015 (see table 2). The rising indebtedness linked to increasing house prices therefore poses a heightening risk.

Finansinspektionen finds that higher house prices and the related increase in indebtedness primarily increase the risks to the macroeconomic development. This occurs because risks of a drop in house prices increase, while at the same time heavily indebted households become more sensitive to financial strains.<sup>12</sup> It was in light of this that Finansinspektionen, in March 2015, submitted for consultation a proposal to introduce an amortisation requirement for new mortgages that would start to apply as of August 2015. The measure was aimed at reducing the sensitivity of Swedish households to economic shocks such as a drop in house prices, thereby making the Swedish economy more stable. In some of the consultation responses, it was questioned whether Finansinspektionen is entitled by law to introduce amortisation rules. Finansinspektionen determined that the powers of the authority to devise rules in the area need to be clarified, and thus decided to put further regulatory work on hold.

Since an amortisation requirement would probably have had a curbing effect on house prices and household lending, and hence on the credit gap, it would also have helped curb risks in the financial system. Since, when setting the buffer rate, Finansinspektionen also takes into account other measures taken to manage systemic risks, the amortisation requirement could affect this decision. The motivation for the latest decision<sup>13</sup> regarding the countercyclical buffer rate also describes how the intended amortisation requirement was one of the reasons for keeping the buffer rate unchanged.

Thus, the fact that the proposed amortisation requirement will not be introduced in August 2015 is now a factor that weighs in favour of an increased countercyclical capital buffer. Without the amortisation requirement, credit growth and the increase in house prices will probably be higher than they would otherwise. In Finansinspektionen's opinion, the absence of the amortisation requirement means that annual credit growth for the household sector will be at most 0.2–0.3 percentage points higher for a number of years than what it would have been had an amortisation requirement been introduced as planned. This is a relatively small change, but means that systemic risks increase somewhat faster. There is thus reason to increase the countercyclical capital buffer in order to increase resilience in the banking system, and thereby improve the possibilities of managing potential problems.

In Finansinspektionen's view, an amortisation requirement should be introduced in order to manage the risks linked to household indebtedness. One

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<sup>12</sup> FI (2014), *Stability in the financial system*. Published on fi.se on 10 December 2014. See also FI (2015), *Proposal for new rules regarding mortgage amortisation requirements*. Published on fi.se on 11 March 2015.

<sup>13</sup> FI (2015), *Decision regarding the countercyclical buffer rate*. Published on fi.se on 17 March 2015, FI ref. 15-3226.

way of introducing an amortisation requirement would be the Government and Parliament bestowing clear authorisation upon Finansinspektionen that enables the requirement to be introduced, albeit later than proposed. If an introduction can occur in the relatively near future, Finansinspektionen is of the opinion that Swedish banks will continue to highly adapt to a forthcoming requirement. Therefore, the effects on credit growth of a short-term deferral of the amortisation requirement would be less than described above.

In summary, Finansinspektionen finds that the systemic risks linked to financial imbalances have increased somewhat, both compared with September 2014 when the buffer was set at 1 per cent, and compared with the first quarter of 2015 when Finansinspektionen decided to leave the buffer unchanged. Credit growth has accelerated, house prices are rapidly on the rise and there is a risk of the absence of an amortisation requirement potentially contributing to somewhat higher credit growth. At the same time, lending to non-financial corporations has recovered, which Finansinspektionen previously considered posed an obstacle to a higher buffer rate. Finansinspektionen's overall assessment based on the quantitative and qualitative analysis is that the countercyclical buffer rate shall be increased to 1.5 per cent.

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

Finansinspektionen ascertains to start with that the consulted bodies have divided opinions in terms of the proposal regarding an increased countercyclical buffer. Arguments have been put forth for an even higher countercyclical buffer rate than that proposed by Finansinspektionen, while at the same time other consulted bodies have argued that the buffer level should not be increased.

The Riksbank, for example, finds that the buffer not only needs increasing to a much higher level than Finansinspektionen's proposal, but also that it should be introduced within a shorter period than twelve months. This is with reference to the fact that systemic risks have been built up over a long period of time and that the build-up of risk has accelerated recently, which would provide exceptional grounds justifying a faster introduction. The National Debt Office, on the other hand, is doubtful about an increase in the buffer and finds that the increase in systemic risks is limited, and that the change in lending is moderate. Finansinspektionen's analysis above shows that the systemic risks linked to financial imbalances have increased somewhat recently and that credit growth continues to accelerate. It is in light of this development that Finansinspektionen is now increasing the countercyclical buffer in order to strengthen resilience in the banking system. That said, Finansinspektionen nevertheless judges that credit growth is not so drastically high as to motivate a buffer rate that is even higher than 1.5 per cent. Although credit growth is accelerating today, the build-up of risk is not so exceptionally high as to require a faster introduction of the measure than that which shall usually apply by law.

In this context, it is important to point out that the countercyclical buffer is intended to manage cyclical systemic risks linked to excessive credit growth, and not all systemic risks, including of the structural kind. In order to manage systemic risks of a structural nature and risks linked to the mortgage sector, Finansinspektionen has already introduced higher capital requirements for banks in the form of a systemic risk buffer, capital conservation buffer, higher capital requirements within Pillar 2<sup>14</sup> and has introduced a risk weight floor of 25 per cent for mortgages. Combined, these measures aim to manage risks that have built up previously and prevent them from increasing further.

Some of the viewpoints of the consulted bodies relate to the factors at the basis of Finansinspektionen's assessment of the buffer level. Both the Swedish Bankers' Association and The Swedish Savings Banks Association express that the primary reason for the increase in the buffer is that the amortisation requirement will not be implemented in August this year. In light of this, Finansinspektionen wishes to emphasise once more that decisions on the countercyclical buffer rate are based on both quantitative factors and qualitative assessments of the sustainability of the credit development and the level of systemic risks. When setting the buffer rate, Finansinspektionen also takes account of other measures taken to manage systemic risks. The amortisation requirement is such a measure taken into consideration in the overall qualitative assessment of the need to change the buffer. However, it is not the sole or primary factor affecting the decision. The accelerating credit growth, the heightening risk with rising indebtedness linked to rising house prices, and the absence of an amortisation requirement, combined, provide grounds for the decision to increase the countercyclical buffer.

In terms of the countercyclical buffer guide, Finansinspektionen wishes to emphasise once more that this indicator is the starting point for Finansinspektionen's analysis, but not a decisive factor in the assessment of the countercyclical buffer rate. As also pointed out by the Riksbank in its consultation response, the standardised approach used to calculate this indicator has a number of deficiencies. This is also the reason why there is no mechanical link between the buffer guide and the level of the countercyclical buffer. Thus, the buffer guide cannot be the sole indicator on which the decision regarding the buffer level is based. The National Debt Office expresses that an increase in the buffer could be justified if credit growth continues to increase to such an extent that the credit gap clearly grows and becomes more positive. In Finansinspektionen's opinion, this constitutes attaching far too much importance to one single indicator. With such an approach, it would also take a very long time before the buffer could be increased, despite other relevant indicators and qualitative assessments motivating such an increase.

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<sup>14</sup> Finansinspektionen performs an individual supervisory review and evaluation of the capital requirement for each bank. The extra own funds requirement ensuing from this assessment is often called the capital requirement according to Pillar 2.

The consulted bodies also have diverging opinions in terms of how well-capitalised Swedish banks are. While the Riksbank and the Swedish National Board of Housing, Building and Planning find that banks, based on the leverage ratio, are not well-capitalised, the Bankers' Association finds that the banks are very well-capitalised and therefore remain highly resilient. In its analysis, Finansinspektionen ascertains that the banks' capital strength is still good, but that resilience needs to increase in light of the heightening systemic risks and accelerating credit growth. The fact that the increase in the risk weight floor for mortgages to 25 per cent, carried out in September 2014, would reduce the need for a high countercyclical buffer, as expressed by the Swedish Bankers' Association, is in light thereof not considered to be a sufficient argument for not increasing the buffer. First, systemic risks have increased somewhat since the risk weight floor for mortgages was introduced last year. Second, the countercyclical buffer targets total credit growth and not just mortgages. The fact that systemic risks linked to household mortgages are largely managed through the implemented risk weight floor does not constitute protection for the banks when their corporate customers are indirectly affected by households reducing their consumption in the event of various financial strains. A sufficiently large capital buffer should therefore be built up in order to manage the risks that could cause credit losses on the banks' corporate portfolios and which are not covered by the capital built up through the risk weight floor.

In terms of the effect of an increased countercyclical buffer on the banks' lending, the Swedish Bankers' Association, The Swedish Savings Banks Association and the Association of Swedish Finance Houses convey that lending to the corporate sector in particular might be tightened. This would be in contrast to the Riksbank's rate cuts, which aim to stimulate the Swedish economy. Finansinspektionen ascertains that the capital need arising from the increase in the countercyclical buffer rate indeed entails a cost for the banks concerned. However, this cost is hardly so large that it would lead to banks substantially increasing their household and corporate lending rates, or to a reduction in the banks' incentive to lend to corporations. In this context, it can be mentioned that also the Riksbank finds that the interest rate increases, to which an increase in the countercyclical capital buffer could give rise, are small and that the effect on economic activity in the short term will thus be slight.

Neither is it Finansinspektionen's purpose to influence the banks' lending to their customers by increasing the countercyclical capital buffer. Rather the purpose of the increase in the buffer rate is to increase the banks' resilience by ensuring that they have a sufficiently large buffer that they can draw down when the economy turns and losses materialise in the banking system. While an increased buffer could indirectly affect the banks' lending by reducing demand for credit, because credit would be more expensive for customers, this is merely a side effect, and not the primary purpose of the countercyclical capital buffer.

Many of the consulted bodies have stated that more targeted measures should be taken to control mortgage lending. Finansinspektionen shares the view that surging household indebtedness linked to rising house prices poses a heightening risk. This is also the reason why, in Finansinspektionen's view, an amortisation requirement should be introduced as soon as possible in order to manage the risks linked to household indebtedness. Such a targeted measure is expected to have a curbing effect on house prices and household lending, which could in turn also help curb the risks in the financial system.

In terms of requirements for other measures to strengthen the resilience of banks, such as a minimum leverage ratio requirement and sectoral capital requirements, these are beyond the bounds of the regulations regarding the countercyclical buffer rate and will therefore not be addressed herein. Nevertheless, Finansinspektionen is of the opinion that Swedish banks have a sound resilience to start with.

In the section on the feedback of the consulted bodies, Finansinspektionen also described the Swedish Bankers' Association's view that Finansinspektionen, in the event of the higher countercyclical buffer being introduced, should review the level as soon as the Government issues its decision on the amortisation requirement. Finansinspektionen monitors and regularly analyses lending in the Swedish economy and supplements the analysis with its own qualitative assessments. The quarterly procedure entails that Finansinspektionen continually re-evaluates the level of the countercyclical capital buffer based on developments in the economy and financial conditions, as well as other relevant qualitative assessments.

Finansinspektionen has, in this section, addressed the feedback and arguments put forth by the consulted bodies to the proposal for an increased countercyclical buffer rate. In summary, Finansinspektionen does not change its assessment of the level of the countercyclical capital buffer.

## **2.5 Entry into force**

According to Chapter 7, section 6 of the Buffer Act, a decision to activate or increase a countercyclical buffer rate shall 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. The stated countercyclical buffer rate shall be applied as of 27 June 2016, which is in accordance with the general rule above.

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 the background thereof.

### 3 Impact assessment

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* finds that the impact assessment, in some respects, is of sufficient quality while in other respects it is far too unclear. There is ambiguity in, for example, the effect of the proposal on the firm's costs, time requirement and operations, despite the impact assessment containing a good description of the effect on the firms' capital needs. The Regulation Council further expresses that certain aspects, such as alternative solutions and the consistency of the proposal with EU law, are not addressed at all. Also, the description of particular consideration for the timing of entry into force and the need for specific information initiatives is considered deficient. In summary, the Regulation Council finds, in light thereof, that the impact assessment does not meet the requirements of sections 6 and 7 of the Regulatory Impact Assessment Ordinance (2007:1244).

In light of the Regulation Council's feedback in terms of certain aspects of the impact assessment not being sufficiently clarified, Finansinspektionen has clarified the analysis as regards such aspects. In section 1.3 Finansinspektionen describes that there are no alternative solutions to regulations, and that the regulations are consistent with EU law. A motivation for the entry into force of the regulations is provided in section 2.5. Therein, it is also set out that there are no specific needs for special information initiatives with respect to the timing of entry into force. Other views regarding the impact on the firm's costs are provided in section 3.2 below.

*The Association of Swedish Finance Houses* finds that the impact assessment analysis should contain a broader analysis covering the smaller and more 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. In the opinion of the Association of Swedish Finance Houses, this affects in particular small and medium sized enterprises that do not have access to market financing. However, it also affects their creditors, which are specialised in corporate financing, such as the many financing companies that focus on SMEs.

## 3.2 Consequences for firms

### 3.2.1 *Firms affected*

The countercyclical buffer rate shall be used to calculate the firm-specific countercyclical capital buffer. The firms covered 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. This affects a total of 89 banks, 37 credit market companies, 113 investment firms, 23 fund management companies with discretionary portfolio management, 16 AIF managers with discretionary portfolio management and Svenska skeppshypotekskassan. This totals 278 firms.

On 8 July 2014, Finansinspektionen published on its website Finansinspektionen's regulations (FFFS 2014:12) regarding prudential requirements and capital buffers. According to Chapter 9, section 1 of the aforementioned regulations, 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 a firm-specific countercyclical capital buffer. This possibility of exemption covers 152 firms. Adding to that, groups will also be exempted if they only consist of firms which, at individual level, are exempted from the requirement. In the first quarter of 2015, this means that 140 firms will be exempted from the requirement to maintain a firm-specific countercyclical capital buffer and twelve firms (seven investment firms, four fund management companies with discretionary portfolio management and one AIF manager) will be covered by the requirement to maintain a firm-specific countercyclical capital buffer.

### 3.2.2 *Costs for the firms*

An increase in the countercyclical buffer rate in Sweden to 1.5 per cent carries certain consequences for the banks. Below, the estimated effects of a countercyclical buffer rate of 1.5 per cent are described for the ten largest Swedish banks. Finansinspektionen has estimated the effects based on data for the fourth quarter of 2014. The calculations pertain to the consolidated level.

Finansinspektionen has calculated the firm-specific countercyclical buffer on the basis of the relevant credit exposures reported by each firm to Finansinspektionen for the full-year 2014. The share of concerned credit exposures in Sweden for each firm is given below:

- Nordea: 21 per cent
- SEB: 35 per cent
- Handelsbanken: 51 per cent
- Swedbank: 62 per cent
- SBAB: 96 per cent
- SEK: 62 per cent
- Länsförsäkringar: 100 per cent
- Skandia: 42 per cent
- Landshypotek: 99 per cent
- Kommuninvest: 72 per cent

In order to calculate the firm-specific countercyclical capital buffer, the share of the concerned credit exposure in Sweden, as above, is multiplied by the buffer rate of 1.5 per cent. Buffer rates for other countries have not been taken into account. An increase in the countercyclical capital buffer also affects the specific capital requirement in Pillar 2. This is because the calculation of the basic requirement in Pillar 2, which follows from the current risk weight floor for mortgages of 25 per cent, also includes the countercyclical capital buffer rate. Table 3 below shows the capital need in Swedish kronor resulting from setting the countercyclical capital buffer at 1.5 per cent.

**3 Capital requirements (CET 1) for the ten largest banks in SEK million, effect of increase of countercyclical capital buffer from 1 to 1.5 per cent**

	Increase of the countercyclical capital buffer (1.5 %)	Risk weight floor Swedish mortgages (25 %)	Total capital
Nordea	1 468	411	1 878
SEB	1 065	412	1 477
Handelsbanken	1 231	638	1 868
Swedbank	1 294	806	2 100
SBAB	165	236	400
SEK	271	0	271
Länsförsäkringar	300	62	362
Skandia	88	0	88
Landshypotek	100	10	110
Kommuninvest	24	0	24
<b>Total</b>	<b>6 006</b>	<b>2 574</b>	<b>8 580</b>

The capital need calculated above is the most considerable expense item for the banks concerned. Finansinspektionen does not find that the increase in the countercyclical buffer rate will have any effects in terms of the banks' working conditions, competitiveness or other terms. Neither does the increase entail any considerable administrative expenses for the banks concerned. The present regulations, which were decided in September 2014, entailed that the countercyclical capital buffer was activated and the buffer rate was set at 1 per cent. That buffer rate will be applied by the banks as of September 2015. This means that the banks already have processes in place for gathering, processing and reporting information. The increase in the buffer level changes nothing in this respect. However, the banks must of course update the



information relevant for calculating the firm-specific countercyclical capital buffer on an ongoing basis. This is part of the reporting to Finansinspektionen already done by the banks.

The increase in the countercyclical buffer does not entail any need for further investments or staff changes for the banks concerned. Neither are the focus of the operations or other conditions affected by the amendment to the regulations. An increase in the countercyclical buffer rate to 1.5 per cent is not expected to have any other consequences, such as financial costs, because the change does not imply any new or amended fees for the banks.

As described above, certain small firms are exempted from having to maintain capital to meet requirements for a countercyclical capital buffer. This means that such firms are not affected by the regulations. Hence, they benefit in relation to the affected banks.

### **3.3 Consequences for society and consumers**

The main purpose of the countercyclical capital buffer is to strengthen the resilience of banks and ensure that the banking system as a whole has sufficient capital to sustain the flow of credit to households and corporations, 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.

In September 2014 Finansinspektionen decided to activate the countercyclical capital buffer and set the buffer rate at 1 per cent given the economic conditions prevailing at the time. This buffer rate will be applied by the affected banks as of 13 September 2015. The decision to activate and set the countercyclical buffer has strengthened the Swedish banking system's resilience because the banks have already taken this forthcoming capital requirement into account. An increase in the buffer would further increase resilience in the banking system and contribute to a more stable financial system in Sweden. Ultimately, this also means that future crises might be less costly for society.

Higher capital requirements for the banks generally increase the cost for the affected firms. An argument discussed in this context is that the banks must then compensate themselves for the cost increase by charging consumers higher prices. This need not necessarily be the case. A firm can choose to absorb a cost increase instead of transferring the cost to its customers, particularly when the firm operates on a market that is characterised by efficient competition. However, even if the banks were to choose to transfer the costs entailed by an increased countercyclical buffer to consumers, the effect is judged to be small. Finansinspektionen's calculations, which are based on very conservative assumptions, show that an increase in the countercyclical buffer rate to 1.5 per cent would give rise to an effect on the mortgage rate of a maximum of 0.01-0.02 percentage points (1-2 basis points). Such a rate hike

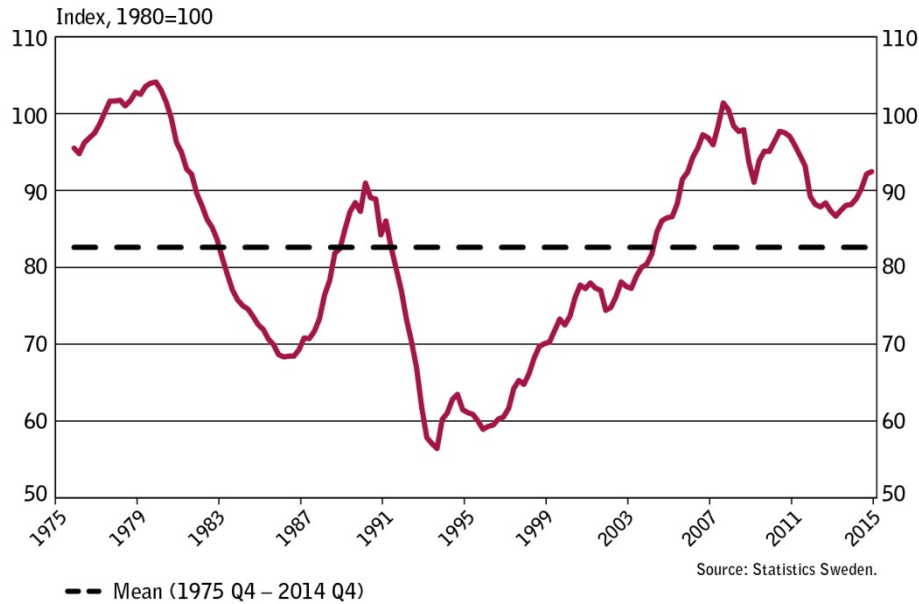
would only very negligibly curb demand for credit and demand in the economy at large.

### **3.4 Consequences for Finansinspektionen**

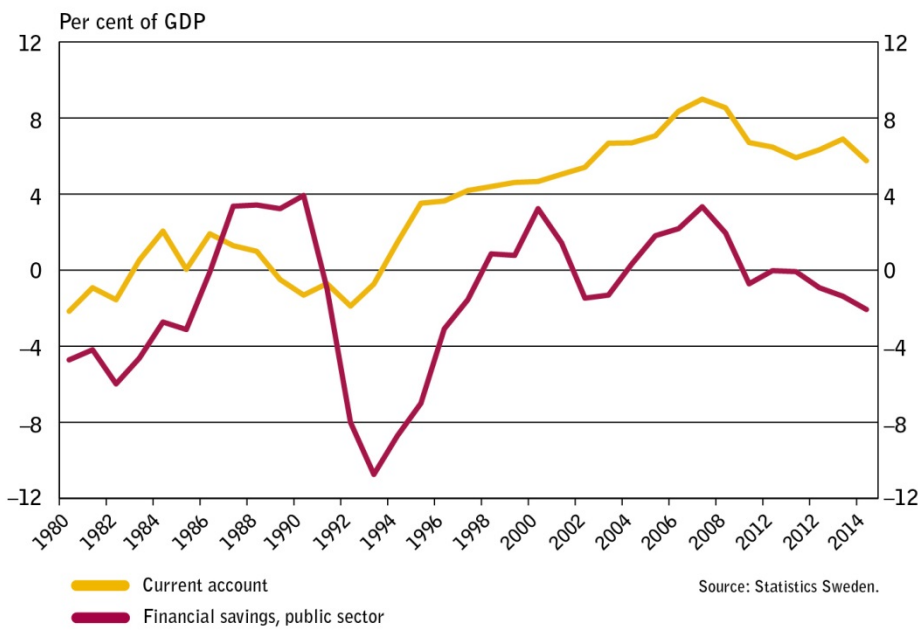
Finansinspektionen assesses and sets the countercyclical buffer rate for Sweden on a quarterly basis. This work includes monitoring and analysing a series of different relevant indicators, calculating the credit gap indicator and otherwise making an overall assessment based on both qualitative and quantitative rationales when deciding on the buffer rate. Finansinspektionen already conducts such tasks as part of its ongoing work regarding capital requirements for Swedish financial institutions and financial stability. An increase in the buffer thus does not involve any additional costs for the authority.

## Appendix 1

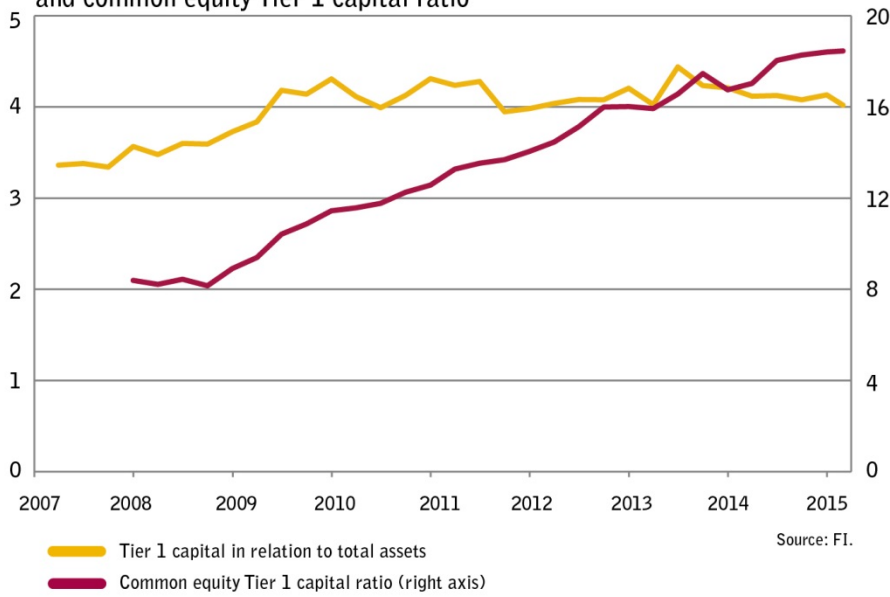
### B 1.1 House prices in relation to disposable income



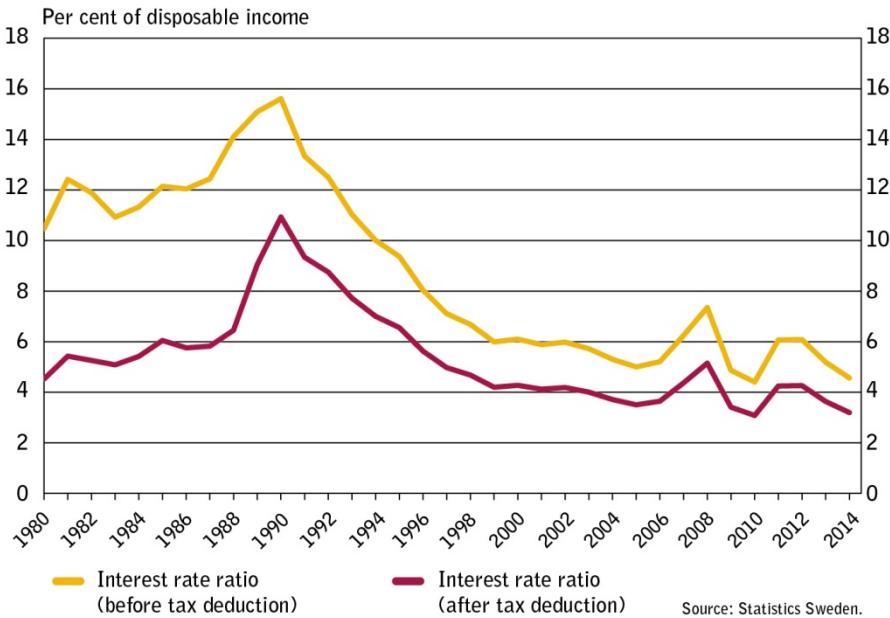
### B 1.2 Current account and financial savings in the public sector



**B 1.3 Tier 1 capital in relation to total assets and common equity Tier 1 capital ratio**



**B 1.4 Interest rate ratio of households**



**B 1.5** Real equity prices



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

Source: Statistics Sweden and Reuters Ecowin.