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D E C I S I O N

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Countercyclical buffer rate

Decision by Finansinspektionen

Finansinspektionen has decided not to amend Finansinspektionen's regulations (FFFS 2014:33) regarding the countercyclical buffer rate.

The case

Finansinspektionen (FI), in accordance with Chapter 7, section 1 of the Capital Buffers Act (2014:966), shall set a countercyclical buffer guide and a countercyclical buffer rate each quarter.

The countercyclical capital buffer for Sweden was activated on 8 September 2014. The buffer rate was set at 1 per cent and went into effect on 13 September 2015.[1] On 22 June 2015, FI decided to raise the countercyclical buffer rate to 1.5 per cent. This rate was applied as of 27 June 2016.[2] On 14 March 2016, FI passed a new decision to raise the countercyclical buffer rate from 1.5 per cent to 2 per cent. This rate was applied as of 19 March 2017.[3]

FI intends to provide approximately once a year a more detailed account of the considerations underlying the decision. This Decision Memorandum is therefore longer than the memorandum for the corresponding decisions taken the past year.

Reasoning and considerations

The purpose of the countercyclical capital buffer is to maintain the banks' resilience. It shall ensure that the banking system as a whole has sufficient

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[1] FI (2014), *Föreskrifter om kontracykliskt buffertvärde.* Published on www.fi.se on 10 September 2014, FI Ref. 14-7010. An English translation is available on FI's website.

[2] FI (2015), *Ändring av föreskrifter om kontracykliskt buffertvärde.* Published on www.fi.se on 23 June 2015, FI Ref. 15-7062. An English translation is available on FI's website.

[3] FI (2016), *Ändring av föreskrifter om kontracykliskt buffertvärde*. Published on www.fi.se on 15 March 2016, FI Ref. 16-742. An English translation is available on FI's website.

capital to sustain the flow of credit to households and corporations following shocks to the financial system that could cause a credit crunch. The countercyclical capital buffer is a time-varying capital requirement. This means that the buffer is activated when financial imbalances, and hence systemic risks, are judged to be increasing. In an ensuing recession or in the event of major losses for the banks, the buffer requirement may be reduced to counteract more restrictive lending and thereby alleviate the economic downturn.

FI decided on 25 October 2017 not to change the countercyclical buffer rate. This meant that the buffer rate of 2 per cent, which had applied since 19 March 2017, would continue to apply. The countercyclical buffer guide was set at 0 per cent.

FI sets the countercyclical buffer rate for Sweden by means of a qualitative assessment that takes quantitative factors into consideration. The single most important factor is the rate of growth of debt among households and firms. FI therefore monitors debt carefully and in particular how it develops in relation to the gross domestic product (GDP) and the disposable income of households. The buffer guide is also used as an indicator to assess the level of the countercyclical buffer rate.

Continued high growth of total debt
Household and corporate debt have increased at a faster pace than nominal GDP since the end of the 1990s (Diagram 1), with a few exceptions. Debt has also continued to increase at a faster rate than GDP over the past year. In Q3 2017, total debt grew by 7.4 per cent at an annual rate, which is approximately the same growth rate as the previous quarter. Nominal GDP in the third quarter rose at the same time by 4.9 per cent. As a result, total debt in Q3 2017 corresponded to 151 per cent of the GDP.

Diagram 1: Total debt and nominal GDP

Annual change in per cent

Legend: Nominal GDP — – – GDP, average 1996 Q1-2017 Q3 — Total lending
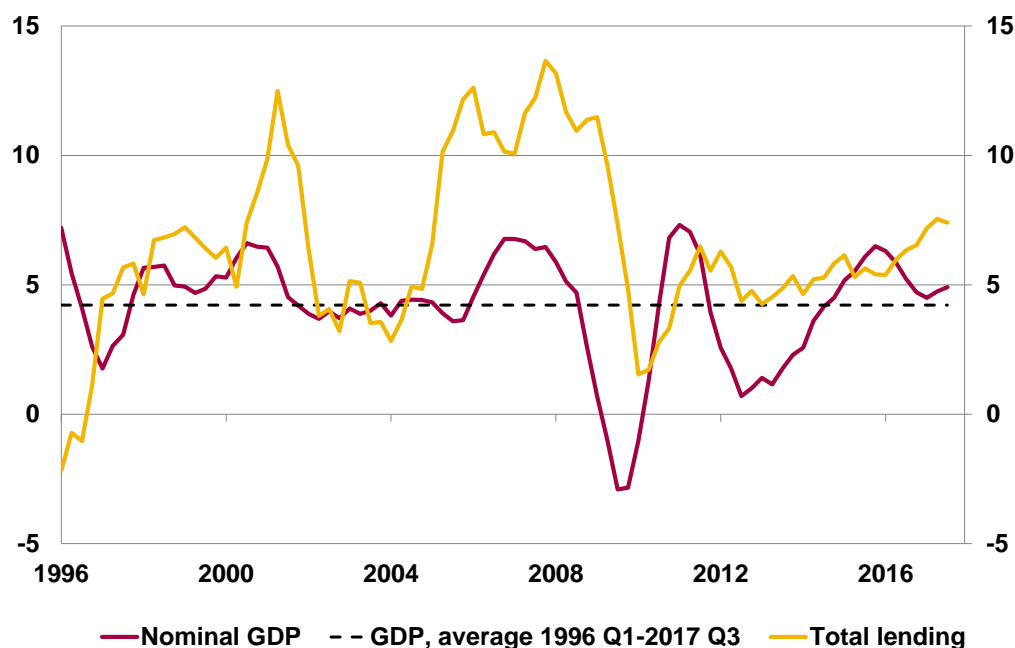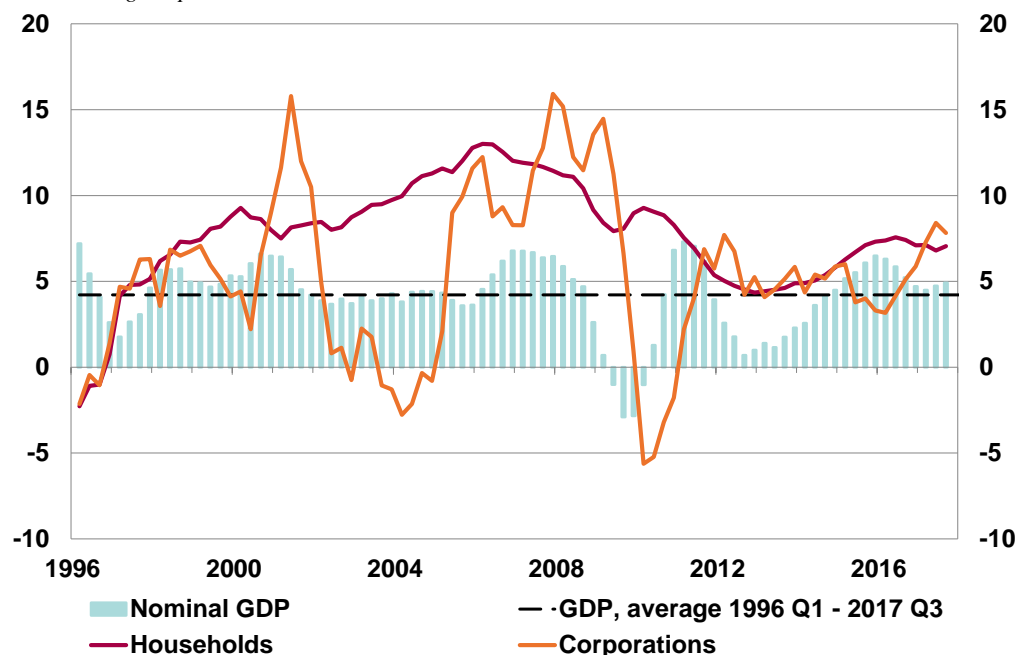
Note: Seasonally adjusted.

Source: SCB.

Continued strong growth in lending to households

Lending to households has been increasing at a faster rate than the nominal GDP since the end of the 1990s (Diagram 2). This trend continued in Q3 2017; the annual growth rate rose slightly (to 7.0 per cent) compared to the previous quarter. This has been the rate of growth for the past two years. Monthly statistics from SCB show that the annual rate of growth in lending to households of 7.1 per cent did not change in October and November.

Diagram 2: Household and corporate debt and nominal GDP

Annual change in per cent

Nominal GDP — · GDP, average 1996 Q1 - 2017 Q3
Households — Corporations

Note: Seasonally adjusted.

Source: Statistics Sweden.

The growth in household debt reflects the growth in household mortgages since household debt largely consists of mortgages. An increase in house prices, therefore, can also lead to a rapid increase in household debt. Swedish house prices have increased sharply in recent years (Diagram 3). Prices have also been rising at a faster pace than household income for a long time, despite strong growth in disposable income (Diagram B.1). In relation to household income, house prices are at their highest level in 40 years. Housing costs as a percentage of income are at the same time historically low due to the low interest rates (Diagram B.4).

Diagram 3: House prices in Sweden

Index 100 = January 2005
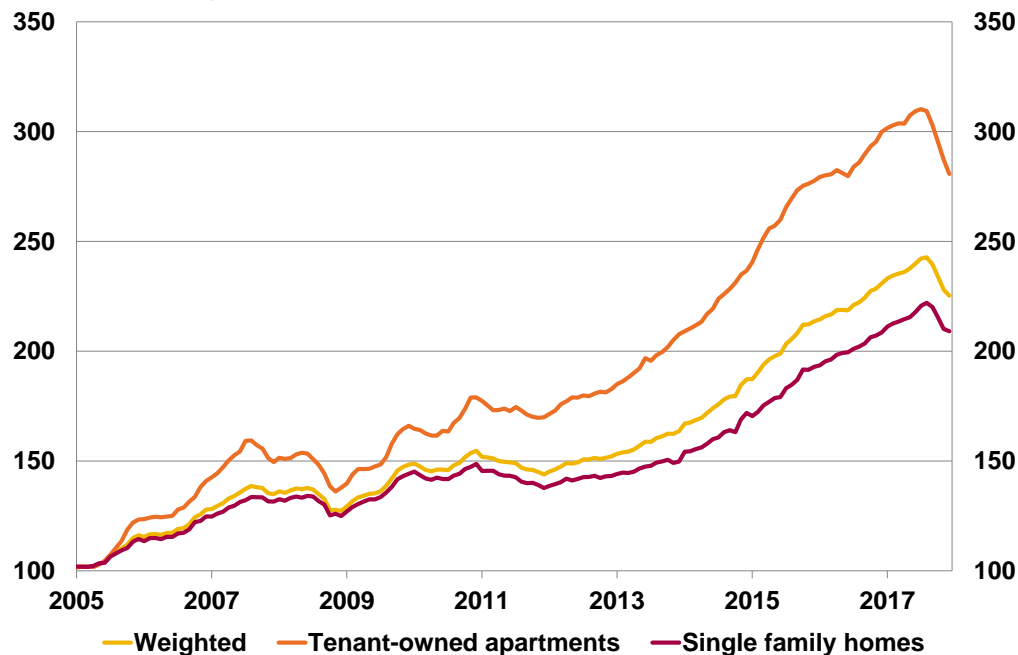
Note: Seasonally adjusted.

Source: Valueguard and FI.

The housing market has cooled slightly during the second half
of 2017, and the rate at which house prices are increasing has slowed. For the
housing market as a whole, prices in December were 2.5 per cent lower than in
the same month the previous year, although this trend varies between
geographic areas and types of objects. The slow-down is most evident in
Stockholm, where prices of tenant-owned apartments are approximately 9 per
cent lower than in December 2016. Households are being more cautious when
buying a home at the same time as the supply of homes increased after the
summer. This increase in supply is largely due to the greater number of newly
produced homes that are for sale. The number of bids per object fell over the
past few months at the same time as the average time an object is on the market
increased.

Corporate debt continues to grow rapidly

Corporate debt increased sharply in the past year. This debt, which consists of
loans from monetary financial institutions (MFIs) as well as market financing
via bonds and commercial paper, increased by 7.8 per cent annually in Q3
2017 (Diagram 2). This increase is primarily due the continued increase in Q3
2017 of corporate borrowing via the market. This increase amounts to 15.5 per
cent on an annual basis, which can be compared to the increase in Q2 2017 of
16.0 per cent. Lending from MFIs to non-financial firms increased by 4.4 per
cent on an annual basis in Q3 2017, which is lower than the 5.1 per cent growth

in the previous quarter. It should be noted that corporate loans generally grow at a more irregular rate than household debt.

Small changes in the forecast for total debt
As a complement to its outcome analysis, FI also uses forecasting models for household and corporate debt. These forecasts predict how debt could develop over time and help FI plan its work with the countercyclical capital buffer.

The household model contains debt, property prices, the National Institute of Economic Research's (NIER) household confidence (economic activity) and a mortgage rate. The corporate model contains debt, a business tendency indicator (economic activity) from NIER and a corporate borrowing rate.[4] FI also uses a model that joins together GDP, wages and the repo rate with the variables included in the two models. The models' forecasts for individual variables depend on both how the other variables develop and the long-term normal level. The normal level is determined by a combination of assessments and information from data sets. The normal level for debt in this case is that it shall grow in line with nominal GDP. The models are assessed on the basis of their forecasting performance and how well the estimated correlations between the variables coincide with economic theory. In the analysis that is presented here, the models are based on outcomes up to and including Q3 2017. The forecasts for debt are conditional on NIER's macroeconomic assessment from December 2017.

Household debt is growing faster than the normal level during the entire forecast period (Diagram 4). The forecast for the rate of increase in household debt has been revised upward since the previous forecast occasion. This is because the debt outcome in Q3 2017 was slightly higher than expected and NIER's confidence indicator for households was very strong in Q4 2017. However, no consideration was taken in the forecast for the slow-down in house prices during the second half of 2017 since the forecast model is based on Statistic Sweden's real estate price index, which lags by several months. The forecast also does not take into consideration the introduction of the stricter amortisation requirement, which will go into effect on 1 March 2018. The requirement is expected to slow house prices by approximately 1.5 per cent and household debt by almost 4 per cent. This means that it is probable that the forecast for household debt will be revised downward in the future.

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[4] For a description of the approach and the household model, see FI (2015), *A Model for Household Debt*, FI Analysis No. 4. Published on www.fi.se on 1 December 2015.

Diagram 4: Forecast for household nominal debt

Annual change in per cent
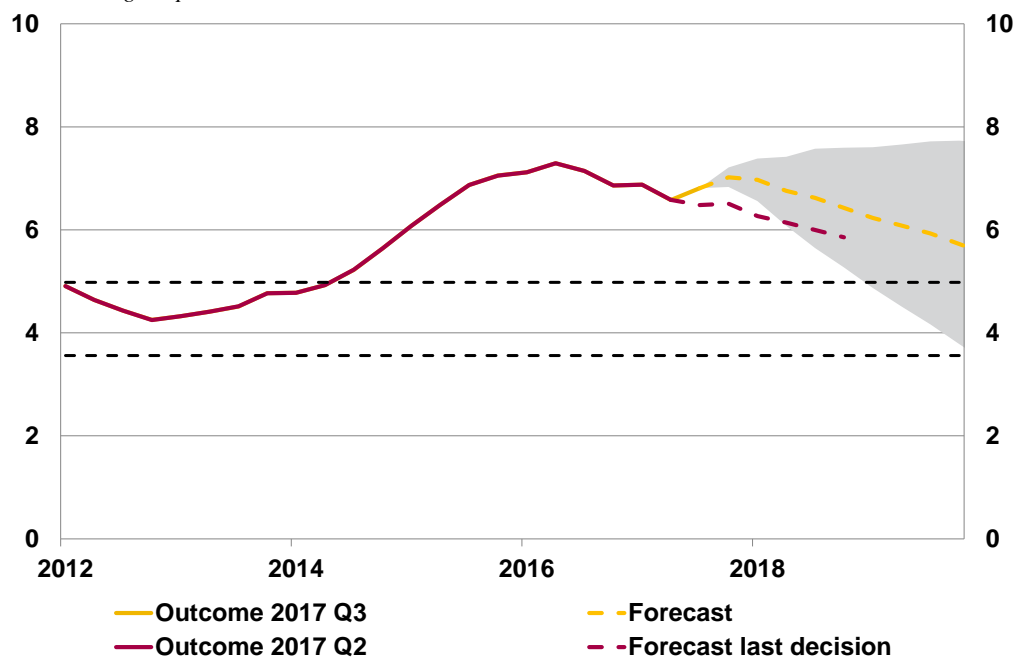
Note: Seasonally adjusted. The grey area shows the 68-per cent probability interval for the current forecast. The area between the black, dashed lines marks a 95-per cent probability interval for growth of nominal GDP in a normal state.
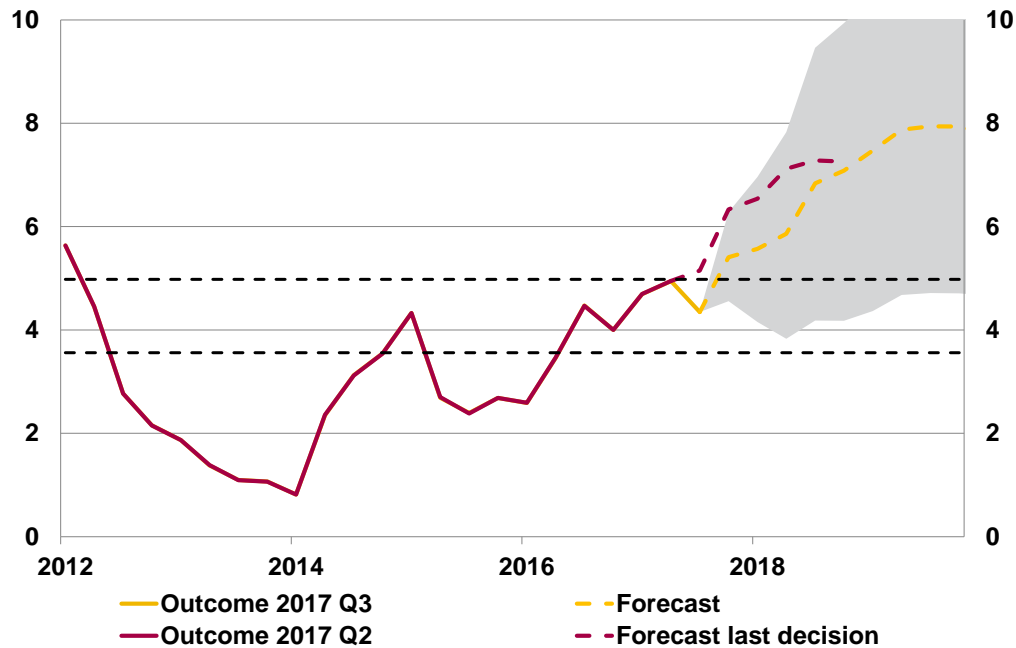
Source: FI and SCB.

Corporate debt from MFIs, according to the model estimate, is more sensitive to interest rates than household debt. The low interest rates and the strong business cycle explain the stronger rate of growth over the next few years (Diagram 5). Corporate debt is expected to increase faster than normal. The forecast for corporate debt is lower than the forecast in September since the outcome for the third quarter was lower than in the previous forecast. However, the forecast does not take into account the decline in house prices during the autumn, which could induce real estate companies to defer or cancel planned projects. If this occurs, corporate debt could increase at a lower rate.

In the current forecast, total debt increases at approximately the same rate as in the previous forecast (Diagram 6). Throughout the entire forecast period, the rate at which total growth is increasing is greater than GDP growth in a normal state, although there is some probability that the forecast may need to be revised downward in the future. As previously mentioned, the forecast takes into account neither the introduction of the stricter amortisation requirement nor the decrease in house prices. Both of these factors can be expected to slow the growth rate of total debt.

Diagram 5: Forecast for corporate nominal debt
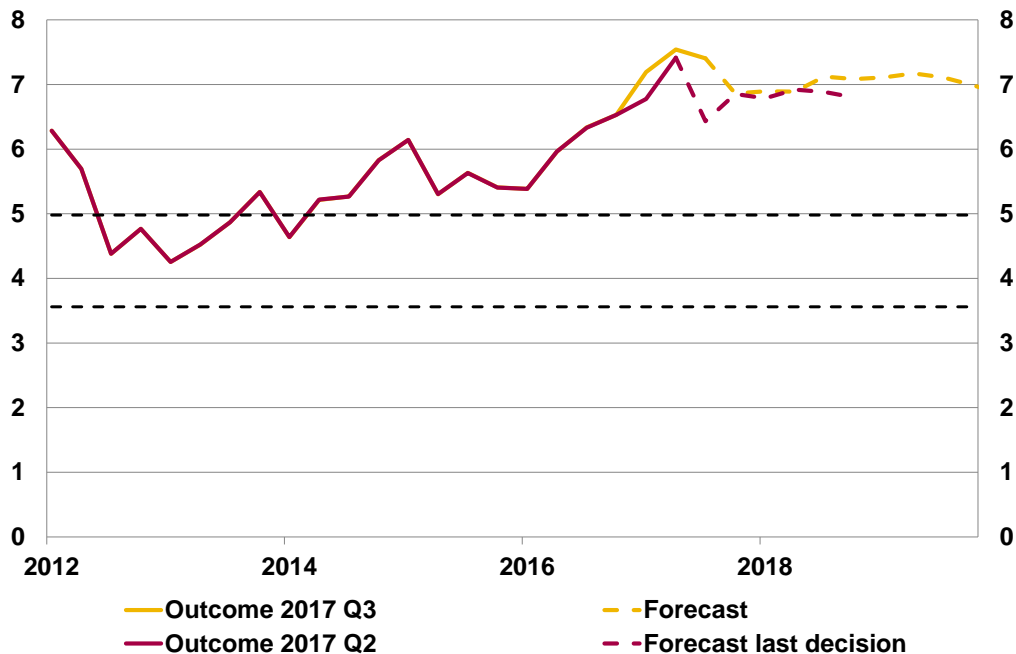
Annual change in per cent

Note: Seasonally adjusted. The area between the black, dashed lines marks a 95-per cent probability interval for growth of nominal GDP in a normal state.

Source: FI and SCB.

Diagram 6: Total nominal debt

Annual change in per cent

Note: Seasonally adjusted. The area between the black, dashed lines marks a 95-per cent probability interval for growth of nominal GDP in a normal state.

Source: FI and SCB.

*Buffer guide and other indicators*

In addition to debt levels, FI also monitors a number of other indicators that offer a comprehensive overview of the risks in the financial system. The buffer guide is one of these indicators and serves as the point of departure for the assessment of how large the countercyclical buffer should be.

The guide is based on the credit-to-GDP gap, which specifies how much the total lending to households and corporates in relation to GDP deviates from its estimated, long-term trend. The credit-to-GDP gap is considered to be a useful indicator for when to activate and raise the countercyclical buffer rate. However, the gap is considered to be less useful for determining when the buffer should be lowered or deactivated. Other indicators are recommended in this respect, such as financial stress indicators. It is important to keep in mind that the buffer guide is one of several indicators; there is no mechanical link between the buffer guide and the level of the countercyclical buffer.

Diagram 7: Credit gap according to the standardised approach

Deviation from trend, ppts
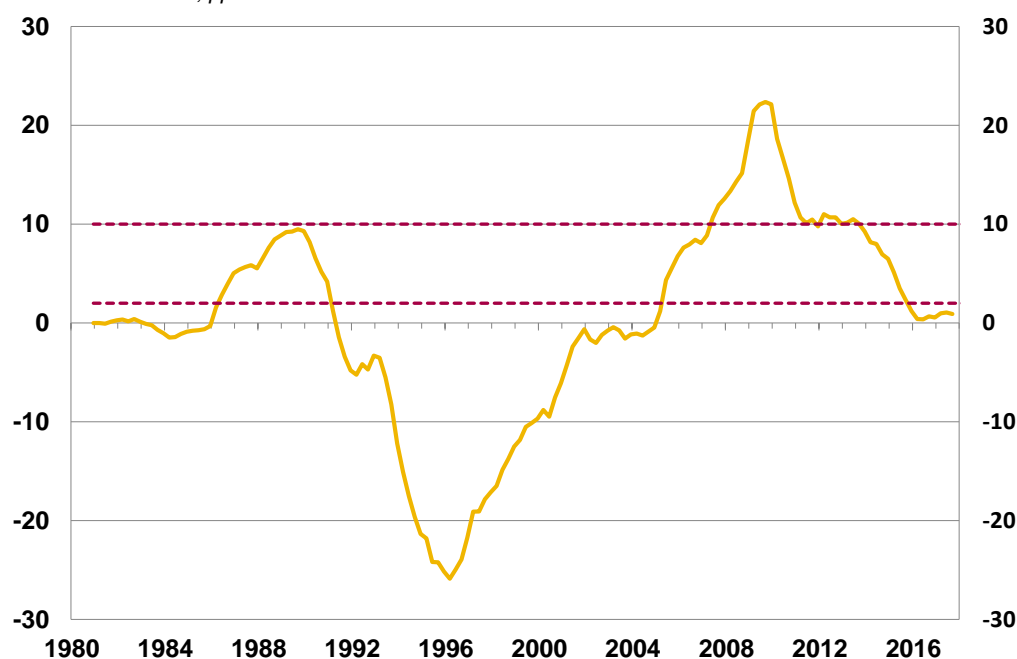
Note: The dashed lines show the thresholds (2 and 10 per cent, respectively) that according to the standardised approach are to be used to transform the credit-to-GDP gap into a buffer guide.
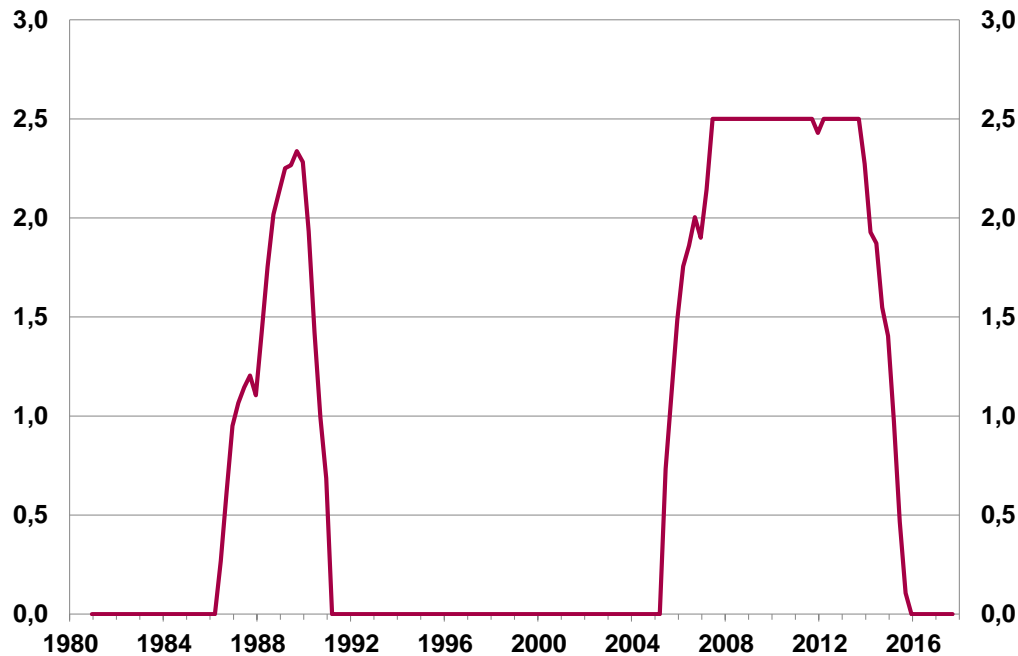
Source: FI and SCB.

FI calculates the buffer guide in accordance with the Basel Committee's (BCBS) standardised approach, which is based on the credit-to-GDP gap. According to this approach, the credit-to-GDP gap is estimated at 0.9 per cent in Q3 2017 (Diagram 7). The size of the credit-to-GDP gap is transformed into

a buffer guide. Because the credit-to-GDP gap is less than 2 per cent, the countercyclical buffer guide is set at 0 per cent (Diagram 8).

Diagram 8: Buffer guide according to the standardised approach
Per cent

Source: FI and SCB.

Additional indicators to determine the countercyclical buffer rate include the current account and financial savings in the public sector as a share of GDP, bank capital levels, interest-to-income ratios of households, developments in real equity prices and financial stress indicators. Some of these indicators are described in the appendix. These indicators show in general that there are no major changes compared to the previous quarter. The financial stress indicators are showing that the stress level on the financial markets is currently low.[5] Banks have high capital buffers, which indicates that the banks in general have satisfactory resilience.

Finansinspektionen's assessment

FI decided in October 2017 not to change the countercyclical buffer rate. FI increased its monitoring of debt at that time since debt was considered to be increasing in a manner that was not sustainable in the long run. This development continued throughout Q3 2017. FI has decided not to change the buffer rate for the current quarter as well. The buffer rate of 2 per cent, which

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[5] See Sveriges Riksbank, *Financial Stability* 2017:2, for the VIX indicator and FI, *Stability in the Financial System,* November 2017, for the CISS indicator.

is stipulated in the regulations, shall thus continue to apply. However, an increase in the buffer rate may become relevant if FI makes the assessment that systemic risks are continuing to build.

FI has weighed into its decision the introduction of the stricter amortisation requirement that will enter into force on 1 March 2018. This requirement is expected to slightly slow the rate at which debt is increasing. FI also took into consideration the decrease in house prices, which indicates that the rate at which debt is increasing will slow in the future.

The countercyclical buffer guide is set at 0 per cent.

A decision in this matter was made by Director General Erik Thedéen following a presentation by Senior Analyst Thomas Eisensee and Analyst Niclas Olsén Ingefeldt. Chief Economist Henrik Braconier and Department Director Magnus Karlsson also participated in the final proceedings.
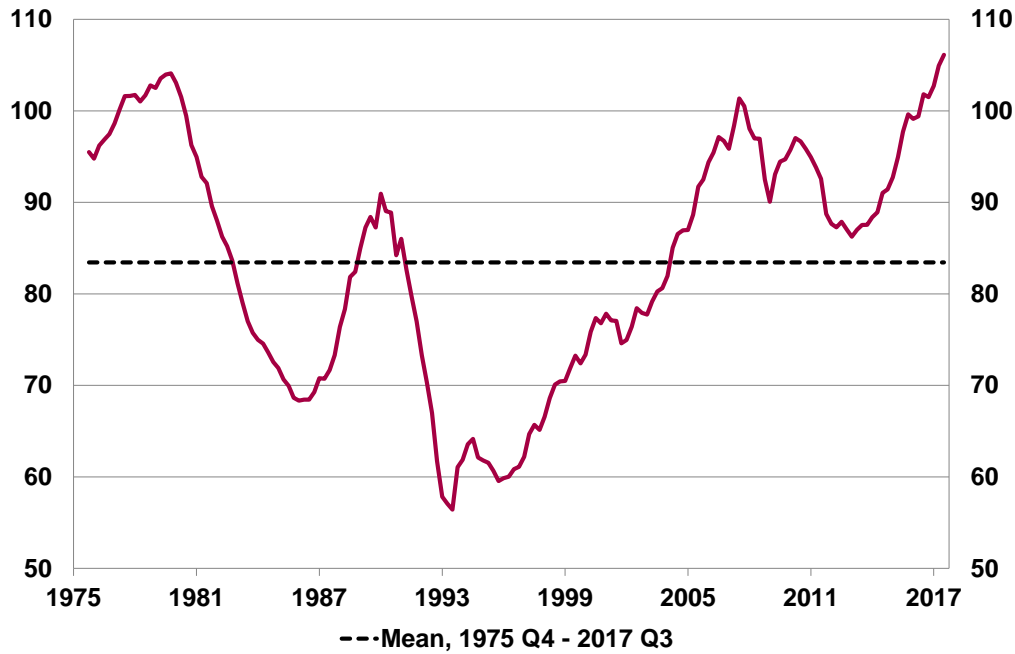

FINANSINSPEKTIONEN

Erik Thedéen
Director General

                Thomas Eisensee
                Senior Analyst

Appendix

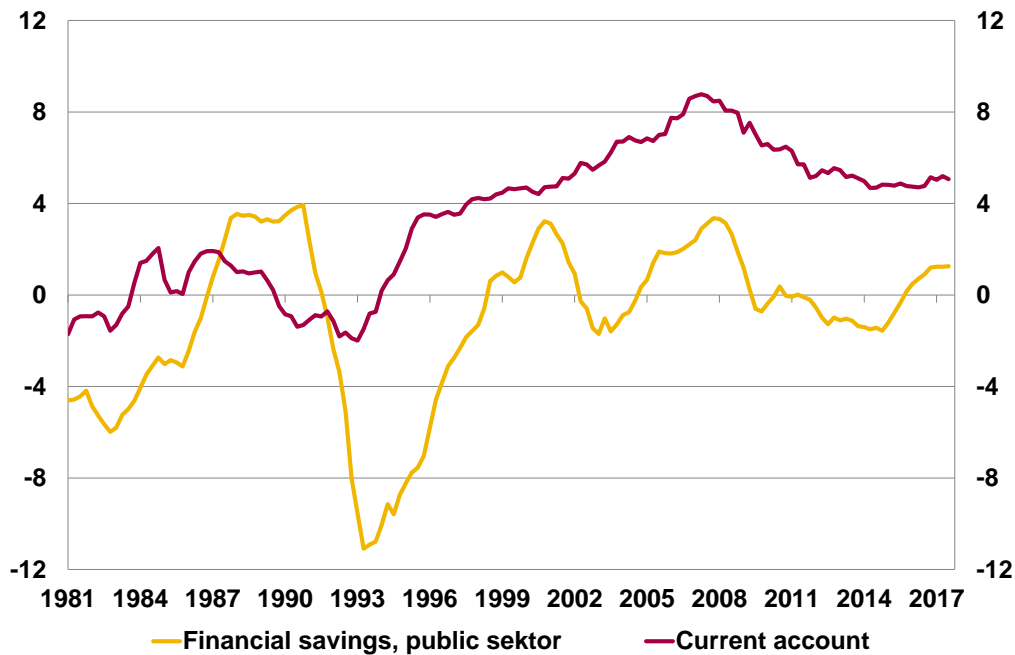*Diagram B.1: House prices in relation to disposable income*

Index 100 = 1980

- - Mean, 1975 Q4 - 2017 Q3

Source: Statistics Sweden.

Diagram B.2 Current account and financial savings in the public sector

Per cent of GDP

Financial savings, public sektor —— Current account
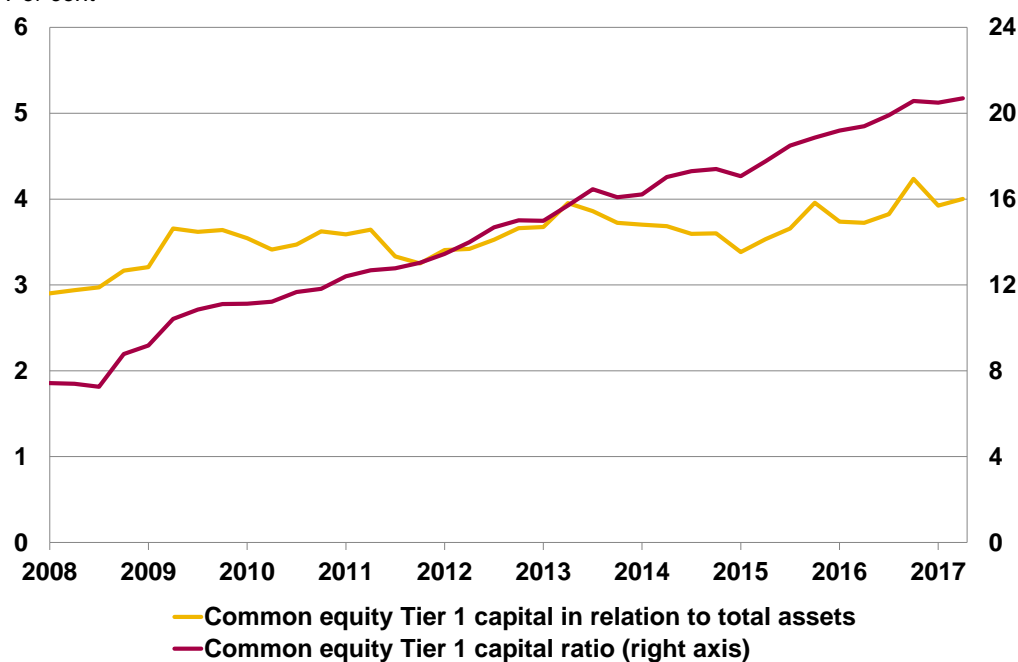
Source: Statistics Sweden.

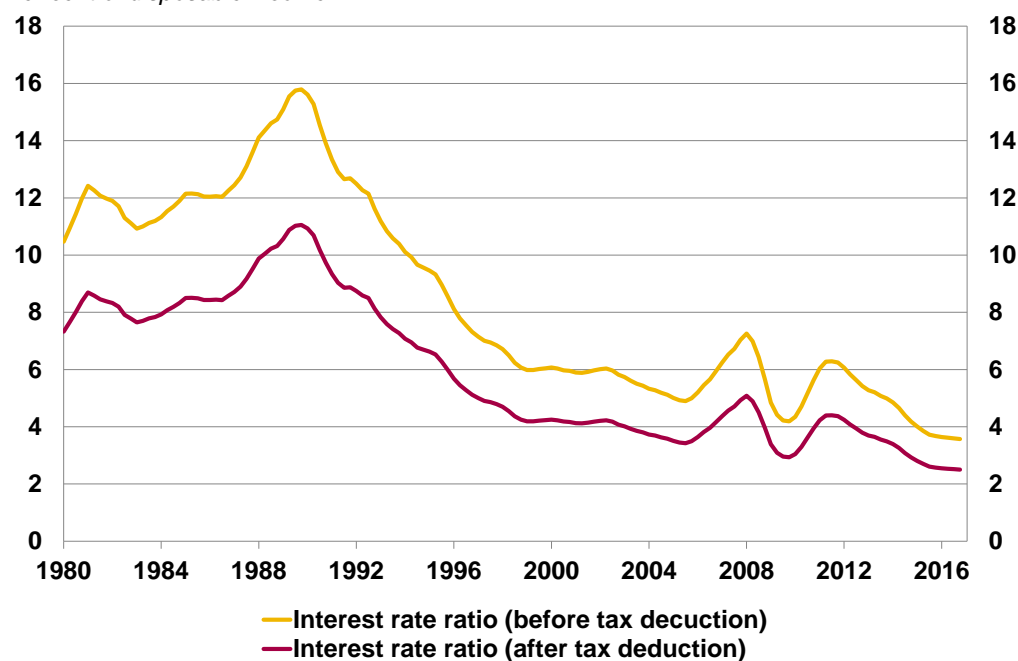*Diagram B.3: CET 1 capital in relation to total assets and the CET 1 capital ratio*

Per cent

— Common equity Tier 1 capital in relation to total assets
— Common equity Tier 1 capital ratio (right axis)

Source: FI.

Diagram B.4: interest-to-income ratio of households

Per cent of disposable income

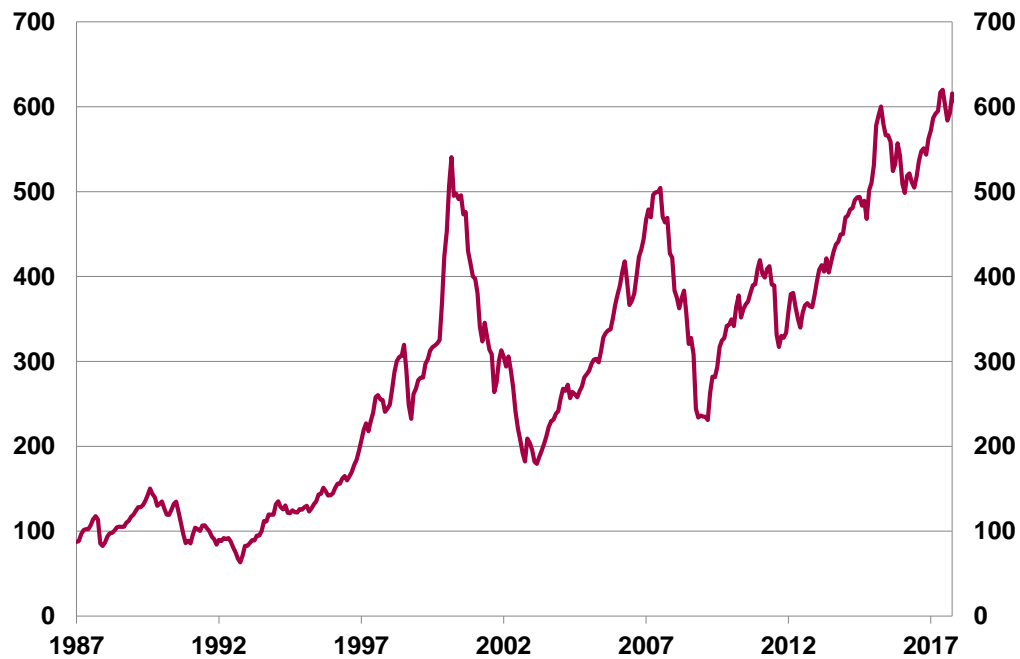— Interest rate ratio (before tax decuction)
— Interest rate ratio (after tax deduction)

Source: Statistics Sweden.

Diagram B.5: Real share prices

Index 100 = 1987

Note: Real share prices have been calculated by dividing OMX by CPIF.

Source: SCB and Thomson Reuters Datastream.