FI Supervision

Survey of Market Risks in Savings Banks

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FI supervision

Finansinspektionen frequently publishes supervision reports in a numbered series. These supervision reports are part of FI's communication. The reports describe the investigations and other supervision carried out by FI. Through these reports, FI presents its observations and assessments as well as its expectations in various matters. This information can support firms in their operations.

Summary

There are indications that some savings banks do not have a sufficient internal control of their market risks. This may lead to unexpectedly large losses. Depending on the circumstances, the lack of control could also mean that these savings banks are not complying with the applicable regulations concerning measurement, governance and control of market risks.

This appears in a survey that Finansinspektionen (FI) has conducted of the management of market risks by savings banks and of their holdings in financial assets. However, FI's assessment is that the majority of savings banks are managing their market risks in an acceptable manner.

The survey also shows that many savings banks are holding a relatively large portion of their financial assets for the purpose of yielding a return for their own operations. In order to achieve this, varying degrees of risk are accepted. FI's overall assessment is that the financial assets are generally associated with moderate risk, but that there are some savings banks whose holdings have a higher level of risk.

In this report we present the conclusions from the survey FI conducted in the winter of 2017–2018. The survey encompassed the 59 savings banks that are under FI's direct supervision and was conducted with the aid of an information-gathering process and a questionnaire. In those areas where the survey has indicated there are weaknesses and shortcomings, we will be following up the observations in our supervision.

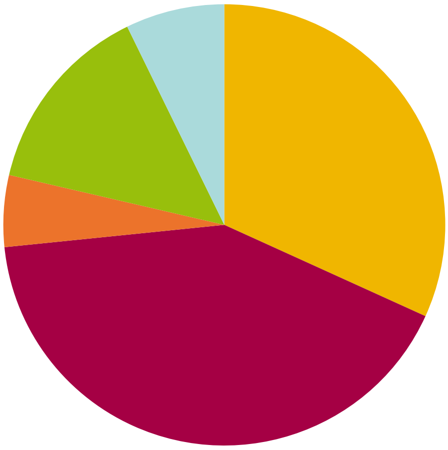
What has FI surveyed?

In the winter of 2017–2018, FI conducted a survey in order to verify how the savings banks measure, govern and manage their market risks and whether this is being done in accordance with applicable regulations and guidelines for the management of market risks. One further aim was to identify which risks the savings banks' holdings in financial assets may entail.

OBSERVATIONS FROM FI'S SUPERVISION FORM THE BASIS OF THE SURVEY.

Fifty-nine of the Swedish savings banks are under FI's direct supervision.[1] The total assets of these banks amounted to around SEK 390bn in December 2017, which means that the savings banks are collectively one of the largest participants in the Swedish banking market, alongside the four major banks. The bulk of the savings banks' assets consist of loans to households and companies, but the savings banks also hold some financial assets, such as shares and interest-bearing securities. The financial assets amount to 14 per cent of the savings banks' total assets (see Graph 1).

GRAPH 1. Savings banks' assets (December 2017)



Source: Finansinspektionen.

FI's supervision also includes ongoing monitoring of the risks and financial development of the savings banks, which takes place via means such as analyses of key financial indicators. The supervision also encompasses in-depth analyses and investigations, as well as the supervisory review and evaluation process (SREP) that targets individual firms. In the ongoing supervision, FI has noted that some savings banks have holdings of financial assets that are significantly larger than the average for the savings bank sector. In some banks, the financial assets are the equivalent of as much as just over 30 per cent

1 For a list of these savings banks, see, for example, "Tillsynskategorisering av svenska kreditinstitut för 2018" [Supervisory categorisation of Swedish credit institutions for 2018], http://www.fi.se/contentassets/58c785ac536c4512be8a76158a3d994e/tillsynskategorisering-svenska-kreditinstitut-2018.pdf.

of total assets and around 200 per cent of own funds. FI has also noted that some savings banks hold financial assets that are associated with a higher risk, for example corporate bonds with low credit ratings.[2]

The fact that the savings banks hold financial assets is not remarkable in itself. The majority of banks, regardless of the focus of their business or size, hold a certain amount of financial assets. One important reason for this is that banks need to have liquid assets as a liquidity reserve so they are able to manage unexpected cash flows and comply with the regulatory requirements concerning the liquidity coverage ratio[3] (LCR). Holding financial assets is also a way of managing excess liquidity.

Banks need to allocate a certain amount of capital in order to take into account the credit risk associated with holdings of financial assets. This capital is held within the scope of the regulatory minimum capital requirement termed Pillar 1.[4] However, there may be further risks associated with holdings of financial assets, including interest rate risk and credit spread risk. The banks therefore also need to be able to assess whether their securities holdings are associated with such risks and, if so, allocate additional capital in order to have a margin for potential losses. In such cases, capital shall be allocated on the basis of an individual assessment of the bank's risks and risk management within the scope of Pillar 2.[5] In order for the banks not to risk allocating too little capital and suffering from unexpectedly large losses, it is thus important that they have a well-functioning system for measuring risk and sound risk management. Consequently, this survey has focused primarily on verifying how the savings banks are measuring, governing and managing their market risks.

RULES AND GUIDELINES FOR THE MANAGEMENT OF MARKET RISKS

The banks' operations are regulated by statutes including the Banking and Financing Business Act (2004:297). Chapter 6, Section 2 of the Banking and Financing Business Act states that firms shall measure, govern and control their market risks. Firms shall therefore ensure that they have satisfactory internal control. Article 138(b) of the Capital Requirements Regulation[6] states that firms which decide to use the credit assessments produced by an external credit assessment institution shall use them in a continuous and consistent way over time.

2 Low credit ratings denotes ratings up to BB+ according to Standard & Poor's and Fitch, and up to Ba1 according to Moody's. In other words, credit ratings that are below the threshold for investment grade.

3 The requirement concerning liquidity coverage ratio is regulated in the Capital Requirements Regulation: Regulation (EU) No 575/2013 of the European Parliament and of the Council of 26 June 2013 on prudential requirements for credit institutions and investment firms and amending Regulation (EU) No 648/2012.

4 This is regulated in the Capital Requirements Regulation (see note 3). See also the memorandum "Capital requirements for Swedish banks", FI Ref. 14-6258 for descriptions of the constituent parts of the capital requirement and FI's view of this.

5 See also the memorandum "FI's methods for assessing individual types of risk within Pillar 2". FI Ref. 14-14414.

6 See Note 3.

In its supervision, FI adheres to the European Banking Authority's (EBA) guidelines on common procedures and methodologies for the supervisory review and evaluation process (EBA/GL/2014/13). Section 6.3 of these guidelines states that firms should have a documented market risk strategy that has been approved by the management body and a clearly formulated risk appetite. A firm's market risk strategy should be appropriate given its business model and financial circumstances. Firms are also obliged to introduce written procedures and a clear division of responsibility for both the staff who take market risks and for those who monitor, control and report market risks. With regard to risk management, the guidelines state that it is important for firms to have a risk measurement system and for their reporting to take material risks into account. There should also be internal controls and limits in order to ensure that market risk exposures do not exceed acceptable levels. In order to manage any breaches of limits, there should be methods and systems in place that ensure it is possible for such events to be reported quickly to the appropriate level of management so that action can be taken.

INFORMATION GATHERING

FI collected information partly through the savings banks having to submit information about their holdings of financial assets and partly through their responses to a questionnaire. The questionnaire involved the savings banks being asked to respond to a range of questions about the purpose of their holdings of financial assets, about their market risk strategies and about what internal frameworks they have for governing, managing and measuring their market risks.

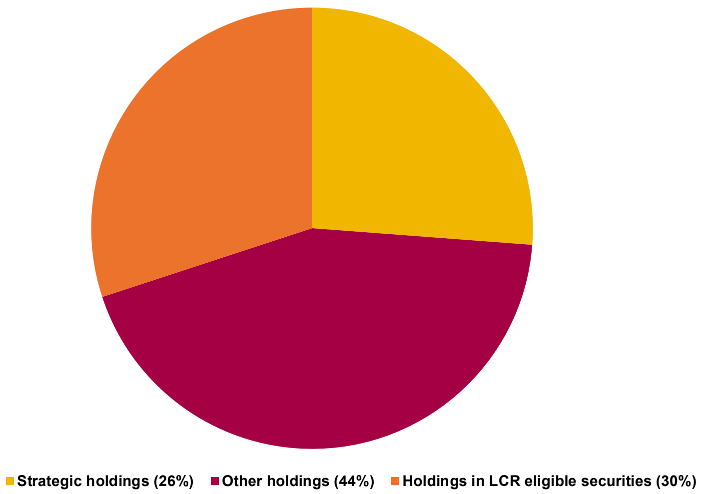
What did FI see in the survey?

The survey shows that a relatively large proportion of the savings banks' financial assets are being held for the purpose of yielding a return for their own operations. In order to achieve this, the savings banks are accepting varying degrees of risk. FI's overall assessment is that the financial assets are generally associated with moderate risk, but that there are some savings banks whose holdings have a higher level of risk. The way market risks are managed is often relatively simple but is deemed to be acceptable in most cases. However, there are some savings banks that are not thought to have a sufficient internal control of their market risks.

THE SECURITIES HOLDINGS HAVE SEVERAL PURPOSES

There are several reasons why the savings banks own securities. Firstly, all of the savings banks are holding highly liquid securities as a liquidity reserve and in order to comply with the LCR requirements. Secondly, the majority of savings banks also own shares in Swedbank and certain other associated companies (referred to below as "strategic holdings"). The savings banks are collectively the largest shareholder in Swedbank and these large holdings ensure both their influence in and partnership with Swedbank, which is important to the savings banks' operations.

GRAPH 2. Distribution of financial assets (December 2016)



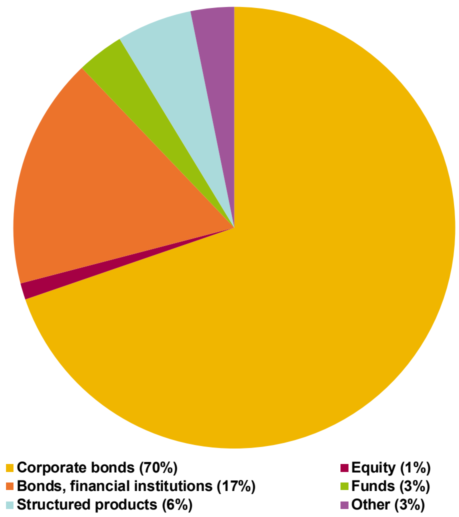
Source: Finansinspektionen.

An analysis of the responses to the questionnaire and other data that is regularly reported to FI shows that liquid securities that are counted as part of the liquidity reserve in the LCR correspond to 30 per cent of the savings banks' total holdings of financial assets (see Graph 2). Almost two thirds of this is made up of covered bonds with high credit ratings and around one third is municipal bonds. The strategic holdings in turn correspond to 26 per cent of the total financial assets and consist largely of Swedbank shares. Holdings of Swedbank shares thus constitute a significant exposure that also has a major impact on the financial performance of many of the savings banks. However, we have chosen in this report not to consider the risks that these shareholdings may entail.[7] Instead, we have decided to focus the analysis on the portion of the financial assets that is classified as neither liquidity reserves nor strategic holdings (referred to below as "other holdings"). These assets consist of investments that the savings banks have for the purpose of investing excess liquidity and yielding a return to their own operations. In theresponses to the questionnaire, the majority of savings banks state that their financial assets have several different purposes. The majority also state that they accept varying degrees of risk in order to obtain a return.

OVERALL MODERATE RISKS ASSOCIATED WITH OTHER HOLDINGS ...

As shown in Graph 3, other holdings are made up of 70 per cent bonds issued by non-financial firms and 17 per cent of bonds issued by credit institutions. The shareholdings are very small when compared with the strategic holdings. The final just over ten per cent of other holdings is made up of instruments that are classified as neither bonds nor shares. These are mainly various types of investment funds, including hedge funds and structured products. They can also be other types of instruments, including insurance products and credit certificates.

GRAPH 3. Distribution of other holdings (December 2016)



Source: Finansinspektionen.

The risk level of the bonds owned by the savings banks varies. However, we are able to conclude that the bulk of the bonds owned by the savings banks are issued by Swedish companies and have the credit rating BBB-/Baa3 or better. Accordingly, these are primarily obligations with an investment-grade rating. Having reviewed all savings banks' bond holdings, FI makes an overall assessment that the risk level of these holdings can be classified as moderate for the majority of savings banks.

… BUT SOME SAVINGS BANKS OWN RISKY SECURITIES

However, some savings banks are distinguished by their higher level of risk. Firstly, FI has identified certain savings banks that are holding

7 The banks cover the risks associated with these holdings using own funds in accordance with Article 36(1)(i) of the Capital Requirements Regulation.

corporate bonds with lower credit ratings. Two savings banks are holding bonds with credit ratings as low as CCC-/Caa3 and more than ten savings banks are holding bonds with the credit rating B/B2. Secondly, it is FI's assessment that some of the instruments that are classified as neither shares nor bonds are associated with a higher risk or high complexity and it is thus difficult to measure their risk. (These instruments are included in the categories funds, structured products and other in Graph 3.) Around 20 savings banks own such instruments.

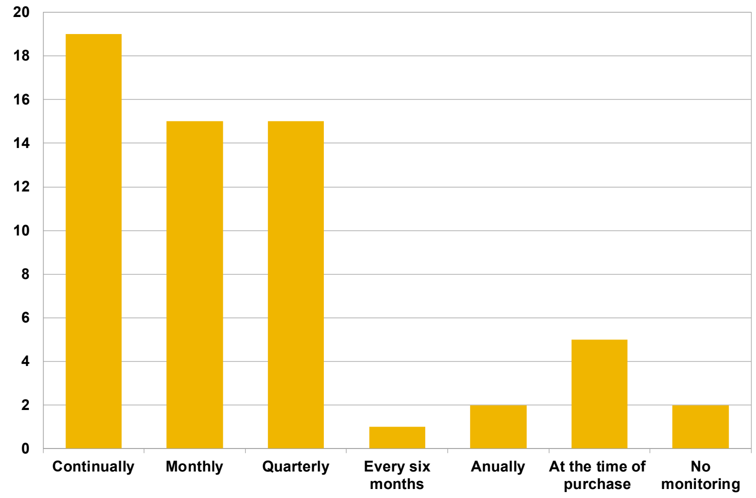
THE MAJORITY OF SAVINGS BANKS GOVERN THE RISK LEVEL USING LIMITS

In the questionnaire, FI asked several questions about how the savings banks govern, measure and manage their market risks. While it is true that the responses to the questionnaire provide no comprehensive picture of the banks' written policies, they do provide an overall picture of the framework of their risk management. Based on the responses, FI is able to conclude that all of the savings banks do at least have some sort of guidelines in place for governing the risk levels of their financial assets, even if the quality of these guidelines has not been verified as part of the survey. Almost all of the savings banks also use limits that stipulate the lowest permitted credit rating that holdings may have, as well as which types of issuer and which types of securities that are acceptable. Some of the savings banks have slightly more advanced limit frameworks that also stipulate the maximum acceptable size of the market risk as a proportion of own funds and the maximum duration permitted in the securities portfolios.

COMMON TO MEASURE RISK LEVEL BY MONITORING THE HOLDINGS' CREDIT RATING

The results from the questionnaire show that the savings banks are measuring and monitoring the risks associated with their financial assets to varying extents. Many savings banks state that they are using portfolio reports from Swedbank, the contents of which include information about the portfolios' total duration, average interest rate and key ratios from standardised stress tests. In addition, the majority of savings banks also monitor the bonds' credit ratings. In the responses to the questionnaire, just over one third of the savings banks state that they monitor credit ratings continually, while around half monitor credit ratings on a monthly or quarterly basis. However, one fifth of the savings banks state that they update the credit ratings very rarely, only at the time of purchase or not at all (see Graph 4).

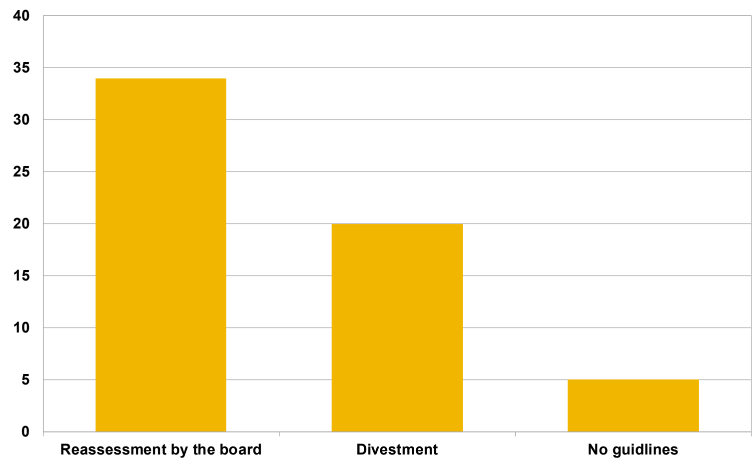
GRAPH 4. Monitoring of credit ratings (number of respondents)



Source: Finansinspektionen.

If the bonds' credit ratings decrease so much that the limits for the lowest permitted credit rating are breached, the majority of the savings banks' guidelines state that the holding shall be reassessed by the board (34 banks) or that the holding shall be divested (20 banks). However, five savings banks do not have guidelines that are applicable in such a situation (see Graph 5).

GRAPH 5. Measures if the credit rating falls below a limit (number of respondents)



Source: Finansinspektionen.

FEW SAVINGS BANKS MEASURE THE CREDIT SPREAD RISK OF THEIR HOLDINGS

For those savings banks that own a large number of bonds issued by non-financial and financial firms, FI's assessment is that the credit spread risk may constitute a material risk. The questionnaire therefore contained a number of questions about whether the savings banks measure the credit spread risk of their bond holdings.

The responses to the questionnaire indicate that only a few savings banks have a quantitative model for measuring the credit spread risk of their bond holdings. A relatively large number of savings banks state that they instead use FI's method for assessing the interest rate risk in the banking book in order to measure the credit spread risk. However, the choice of this method is thought to be based on a misconception because FI's method measures primarily the interest rate risk of the bond holdings rather than their credit spread risk. The interest rate risk is the risk that changes in value of an asset will arise when the general interest rate level changes. This is different from the credit spread risk, which usually denotes the risk that changes in value will occur because the market's assessment of an issuer's repayment capacity changes. Accordingly, a credit spread is defined as the difference between a bond's market rate and the interest rate of a risk-free bond with the same maturity. In addition to the interest rate risk, FI's method also measures the banks' risk in relation to changes in their own financing costs, which may arise if the banks' assets have a longer maturity than their financing.

Conclusions

FI concludes that the savings banks' management of market risks is, in most cases, acceptable and that their assets are generally associated with moderate risk. At the same time, however, the survey shows that some savings banks are not thought to have sufficient control of their market risks, which could, in a negative scenario, cause unexpectedly large losses. Depending on the circumstances, this could also mean that some savings banks are not complying with the applicable regulations concerning measurement, governance and control of market risks. FI is of the opinion that it is important for the savings banks to ensure that their strategies for market risks are appropriate in relation to their operations and overall risk strategy and that risk management takes place in line with the applicable regulations.

THE MAJORITY HAVE ACCEPTABLE RISK MANAGEMENT, BUT THERE ARE EXCEPTIONS

Based on the information from the survey, FI concludes that the management of market risks by the savings banks is, in many cases, relatively simple and lacks, for example, its own quantitative models for measuring the risks of holdings. In those savings banks that have clear guidelines and limit framework, as well as holdings with lower risk and complexity, this is deemed to be acceptable. Nevertheless, FI has identified some savings banks that stand out by demonstrating shortcomings in the measurement and management of their market risks, at the same time as their holdings are deemed to be riskier. As mentioned previously, this relates to factors including the fact that some savings banks are not monitoring the credit ratings of their financial assets sufficiently frequently and that some also lack guidelines for the management limit breaches. The survey also shows that some savings banks are thought to have breached their internal limits and invested in securities with a higher risk than is permitted, or that they have bought securities the quality of which has subsequently deteriorated without this having been identified and managed. Some of the savings banks are also thought to have specified erroneous credit ratings for some holdings in the materials they have sent to FI within the scope of this survey.

All in all, this suggest that there may be some savings banks that do not have sufficient internal control of their market risks. Consequently, these savings banks may need to develop and improve the management of market risks. As long as these shortcomings persist, there is a risk of unexpectedly large losses and the banks may therefore need to hold additional capital over and above the minimum requirement in order to cover this. It is also FI's assessment that these shortcomings, depending on the circumstances in individual cases, could entail that certain savings banks are not complying with Chapter 6, Section 2 of the Banking and Financing Business Act as regards measurement, governance and control of market risks. When it comes to monitoring of credit ratings in order to establish risk weights for capital adequacy, it is FI's assessment that there is a risk that certain savings banks are not complying with Article 138(b) of the Capital Requirements Regulation.

APPROPRIATE STRATEGY FOR AND GOVERNANCE OF MARKET RISKS IS KEY

The survey shows that a large proportion of the savings banks own securities partly for the purpose of yielding a return to their own operations and that they are therefore exposing themselves to varying degrees of market risk. This is in spite of the fact that the savings banks' core business are to be characterised by a low level of risk and focus on offering banking services to individual customers and small and medium sized enterprises.[8] In line with the EBA's guidelines, which were presented previously in this report, FI is of the opinion that it is important for the savings banks' market risk strategies to be tailored to the banks' overall risk strategies. It is also important that the risk appetite is tailored to the expertise the savings banks have. Although the survey shows that the savings banks' risk management is considered by and large to be acceptable and that the risk level is moderate in most cases, FI would like to draw the attention of all savings banks to the importance of ensuring that the strategies and appetites for market risk are appropriate given their business model and the savings bank's financial circumstances.

FI also questions whether it is appropriate for savings banks to invest in riskier or more complex instruments such as hedge funds or structured products. This type of risk-taking places great demands on the ability of the bank, including the board, to understand and manage larger and/or more complex market risks. FI is of the opinion that it is of particular importance for those savings banks that have invested in this type of instrument to conduct a thorough review of their management of market risks and ensure that it is proportionate to the bank's risk exposure and compliant with the applicable regulations. This should include ensuring that there are clear procedures and guidelines both for the staff who make decisions to buy and sell securities and for those who monitor and control market risks. Furthermore, the savings banks that own riskier securities should ensure that their holdings comply with the requirements in their internal policies and that the measurement and reporting of market risks takes place in the correct manner. In those areas where this survey has indicated there are weaknesses and shortcomings, FI will be following up the observations in its supervision.

8 More information about the savings banks' business models can be found at www.sparbankernasförbund.se

Finansinspektionen
Box 7821, 103 97 Stockholm
Besöksadress Brunnsgatan 3
Telefon +46 8 408 980 00
Fax +48 8 24 13 35
finansinspektionen@fi.se

www.fi.se