S P E E C H

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Financial stability and macroprudential policy

Thank you for the opportunity to participate in today's public hearing. The topic is "financial stability and macroprudential policy". I am more than happy to discuss this topic, particularly here with the Committee on Finance.

Finansinspektionen (FI) is tasked with promoting financial stability and counteracting financial imbalances. In line with this, FI is responsible for the microprudential and macroprudential tools for achieving these goals. "Macroprudential tools" refers to measures that reduce systemic risks, i.e. the risk that shocks will make it difficult for the financial system to fulfil its purposes.

Even though FI has been tasked with promoting financial stability since 1995, the financial crisis that occurred almost ten years ago demonstrated that there was something missing from the authorities' frameworks and toolboxes. It was not clear, however, what should be changed and which tools were needed. We have come quite far in analysing these matters, but there is little empirical evidence from applied macroprudential measures other than traditional measures such as capital and liquidity requirements. This is true both for Sweden and internationally.

This is not because FI has been passive. FI introduced the mortgage cap as early as 2010, which should be considered a macroprudential measure regardless of the motivation behind its implementation back then. We have also used capital requirements as both microprudential and macroprudential tools in order to increase the resilience of banks. And, after an arduous journey, FI introduced an amortisation requirement in 2016 linked to high loan-to-value ratios. A new component that is linked to high loan-to-income ratios will be added to this requirement in March this year. The purpose of the mortgage cap and amortisation requirement is to strengthen households' resilience.

Several of FI's measures have been questioned (at least before they were implemented), but some people have also taken the position that FI should be doing more. Regarding the amortisation requirement, FI also wanted to take action earlier.

In order to understand why FI needed to be so active, especially with regard to changing household behaviour, it is necessary to set FI's macroprudential measures into a larger context. I believe that the demands placed on macroprudential policy are in part an expression for imbalances between policy areas. This means that macroprudential policy on its own is not able to steer development in the proper direction, particularly given that its tools are untested as a means of counteracting the strong forces driving household indebtedness. Before I explain the basis for this conclusion, I would like to say a few words about the emergence and organisation of macroprudential policy.

Macroprudential policy – an emerging area

Let me begin with the background. In reality, macroprudential policy is nothing new. Safeguarding a stable financial system has been FI's assignment for almost 25 years, and in practice this has meant that FI has needed to take measures to mitigate systemic risks, which fall under what is today called "macroprudential policy".

One of the fundamental ideas behind macroprudential policy is that responsible authorities must consider risks from a systemic perspective. It is not enough that individual banks are stable and resilient. *Contagion effects* must be included in the analysis – and not just in for liquidity problems. The financial crisis demonstrated what happens when many banks take the same type of credit risks. Capital requirements must take these systemic risks into consideration. Stress tests that expose the entire system to shocks have therefore emerged as an important supervisory tool. It is also not enough that banks *survive* major credit losses. They must also be able to continue to provide the economy with loans even when the economy has suffered a shock. Remember that efforts to mitigate the crisis that occurred almost ten years ago focused largely on supporting the supply of credit. The countries that were most successful at this were also those that recovered fastest (including Sweden). Substantial capital buffers at the banks, in other words, are an important tool for both microprudential and macroprudential policy. This approach has guided FI in its application of the capital adequacy regulations.

Countries where the banks suffered major losses – both during the crisis and in its wake – have focused heavily on recapitalisation of their banks, including building up resilience to new shocks. In Sweden, the supply of credit rebounded quickly after the crisis years. The recovery, however, which in part has been fuelled by credit, has shown us that macroprudential policy is more than just ensuring that banks have large capital buffers; it is about protecting the economy from shocks on the credit markets that spread via other channels than the banks' capital. This has brought lending to households into focus.

The starting point is that a high level of debt can worsen economic downturns when many households simultaneously cut back on their consumption. Imbalances in the credit market, in other words, can reinforce macroeconomic shocks and, as a result, threaten financial stability. One of the tasks for macroprudential policy, then, is to also strengthen resilience in the household sector by avoiding rapid growth in debt, even if feared credit losses do not pose a threat to individual financial institutions. If households are less indebted, this reduces the risk of sharp economic downturns and thus also the risk of financial instability.

The most important tools have been the mortgage cap and the amortisation requirement. Their objective is to ensure that households do not take on more debt than they can handle during an economic downturn or a sharp increase in interest rates without drastically reducing consumption. These types of tools are implemented through the banks' credit assessments. The conditions that banks place on borrowers in addition to FI's minimum requirements also play an important role. The focus is on resilience to shocks and crises, just like in the banking sector.

Macroprudential policy, particularly in Sweden, lies somewhere between traditional financial regulation and crisis prevention (in a broader meaning). I would like to emphasise the word *prevention*. Macroprudential measures are primarily intended to create structures that strengthen the economy's resilience to future crises, both in the financial system and the economy at large. In other words, they are not levers that can be raised and lowered depending on the business cycle.

Some of the measures are conventional regulatory tools, for example capital requirements on banks, that are naturally handled by the supervisory authority. Others, such as the mortgage cap and amortisation requirements, have more of a direct impact on individual households, albeit through requirements on banks, and can thus also affect the distribution of income and wealth.

The breadth of the measures that may be considered has also had an impact on how macroprudential policy is organised. In some countries, the decision-making mandate lies with the supervisory authority (regardless of whether the responsibility for supervision happens to be with the central bank or a separate financial supervisory authority). In other countries, the decision-making mandate lies with the Government. And there are also countries where the measures are laid down by law and thus decided by Parliament. Many countries also have some form of a committee with representatives from the Ministry of Finance, the supervisory authority and the central bank to discuss macroprudential matters.

Sweden has chosen a solution where the responsibility for the analysis and proposed use of macroprudential tools lies with FI, but some measures must be approved by the Government. The fact that the final decision-making mandate lies with the Government reflects the fact that measures such as mortgage caps and amortisation requirements affect individuals and may have an impact on distribution effects. The special character of this type of tool is also evident in that macroprudential measures concerning capital requirements for banks are delegated to FI, in the same manner as other decisions regarding the application of capital requirement regulations.

There is also a Financial Stability Council, which serves as a forum for discussion and exchange of information about all types of matters within the area of financial stability, including macroprudential policy.

Distribution of responsibility between FI and the Government

Allow me at this point to offer my views on the distribution of responsibility between FI and the Government when deciding on macroprudential tools. The regulatory framework establishes that FI shall analyse which measures should be taken, when needed, to protect financial stability and counteract financial imbalances. This reflects the explicit mandate FI has been given for these matters. As a result, FI has a greater capacity for analysing specifically stability risks and appropriate measures than the Government Offices. This distribution of tasks also places the responsibility for taking initiatives on FI as an independent authority, which may mean that the need for measures is identified and acted upon faster than if the responsibility lay entirely with the Government.

FI's proposed measures have also been preceded by thorough and detailed analyses of motives and effects. Before we proposed a stricter amortisation requirement, we published four reports in the FI Analyses series that studied both the vulnerabilities associated with a high level of household debt and the consequences of the potential alternatives.[1] We also draw at times on the expertise of external reference persons, and we wrote an extensive consultation memorandum motivating our proposal and presenting its consequences. The fact that proposals are submitted for consultation ensures their quality and makes it possible to review them once again before we submit them to the Government.

Therefore, it cannot be the legislative body's intention for the Government to start from scratch when analysing problems and potential measures after FI has submitted a proposal for approval. Neither can it be the intention for the Government to use a proposal from FI to initiate an assessment of a wide spectrum of alternative measures. If this were the case, the responsibility would have been placed entirely with the Government. The intention is for the Government to assess the proposed measure. The fact that the Government only can say Yes or No to FI's proposal, i.e. not change the proposal in substance, supports this interpretation.

The Government's considerations should aim to add *new aspects* to the proposal. And there may be questions that the Government should answer, for example:

[1] See FI Analyses Nos. 5, 9, 10 and 11 (http://www.fi.se/en/published/reports/fi-analysis/).

1. Does the Government take a different view of the imbalances and risks that serve as the basis for FI’s proposal? Because the proposal is public and has been submitted for consultation, the Government is able to also consider viewpoints from parties other than FI in its decision.

2. Are there other measures that the Government is considering which would mean that the need for using macroprudential tools is not as large as FI’s analyses indicate? The additional aspect in this case is that the Government may have more information than FI.

3. Is the Government of the view that the measure has a negative effect on other policy areas, for example distribution policy or stabilisation policy? The Government may find it necessary to make different trade-offs between potentially conflicting policy objectives than FI, in its role as a specialist, would make.

If the Government can answer No to these questions, it should be able to decide to grant FI the right to implement its proposal.

This kind of decision-making procedure, which distributes the preparatory and decision-making responsibility between a specialist authority and the Government, is not unique. FI has previously pointed to the similarities to the governance system for the management of central government debt that has been in place now for almost 20 years (and was implemented when I was working at the Swedish National Debt Office). This arrangement is another example of an expert authority being tasked with the analysis and submission of proposals for how a target set by the Parliament can best be achieved. Proposals are submitted to the Riksbank and potentially other bodies for consultation before the Government each year decides on the guidelines for the management of central government debt.

There are differences between the management of central government debt and macroprudential policy, for example how the responsibility is distributed between the Government and the expert authority, how often decisions are made, etc. But I believe the arrangement for the management of central government debt and its procedures, which are now been well established, can provide inspiration for macroprudential policy. The assignment for FI in the Government’s annual Letter of Appropriation to report on methods for the identification and assessment of macroeconomic and financial stability risks as well as the assessment of tools could be a first step in the development of more structured reporting on macroprudential policy, for example. I remember that the Swedish National Debt Office had a similar development assignment when the governance system for the management of central government debt was new.

Challenges facing macroprudential policy

Allow me to return to the current challenges facing macroprudential policy. The fundamental conditions are determined by the developments in the financial system.

FI makes the assessment in its most recent Stability Report, which was published in November, that Swedish banks in general have satisfactory resilience and are able to maintain critical services even given turbulent conditions. They are able to do so because they continue to report good profitability, low credit losses and high levels of capital in relation to the risks in their operations. The banks’ capital consists largely of buffers that can be used as shock absorbers during crises. Swedish banks rely heavily on securities for their financing, but they also have significant liquidity buffers. FI places particular importance on the banks holding assets in USD and EUR, which creates buffers with extra high liquidity during a crisis.

However, we also noted that lending in the household sector is continuing to increase rapidly despite FI’s implementation of an amortisation requirement linked to loan-to-value ratios. There is a risk that this development will create even greater imbalances in the credit market and reduce the economy’s and the financial sector’s resilience to shocks.

Consequently, FI takes the position that the risks associated with an increasing number of households taking large loans are rising and action is needed to strengthen households’ resilience. Macroprudential tools are FI’s most important tool in this respect, and they impact indebtedness through the banks’ credit assessments. In March, the stricter amortisation requirement will go into effect on new loans. The most vulnerable borrowers, i.e. those with high debt in relation to both income and the value of the home, will need to amortise at least 3 per cent of their mortgage a year.

These types of measures allow us to contribute to a more robust economy and financial system. Sweden is one of the countries that has been most active in using macroprudential tools, but these tools are naturally not only applied in Sweden. The United Kingdom, Denmark and Ireland, all of which suffered heavily during the years of the financial crisis, have introduced mortgage caps and loan-to-income limits. They learned the hard way what imbalances can lead to. Norway, where the development is more similar to that of Sweden, also has a mortgage cap and loan-to-income limit.

Thanks to the decision passed by the Riksdag (the Swedish Parliament) in December, FI will have access to a wide range of macroprudential tools starting in February. We are thus better equipped than before.

FI would like to say Thank You for this vote of confidence in our ability to manage these tools. Just like we have so far, we will continue to analyse the developments and take and propose measures as needed. At the same time, however, we must comment on the challenges from the current market conditions that we are facing in our efforts to counteract financial imbalances using macroprudential measures. These challenges are largely related to the unusual economic conditions.

Sweden and many other countries are experiencing a period of stubbornly low inflation. True to their assignments, central banks are pursuing strongly expansive monetary policies. Combined with a persistent decline in long-term interest rates, this means that lending rates are at historically low levels. We are experiencing an economic boom, which in Sweden is showing signs of going over to what normally would be called “overheating”, particularly on the labour market. Despite this, inflation has remained low. Instead, prices of assets, such as homes and shares, have risen. Higher asset prices mean larger loans collateralised by homes. Loans at low interest rates and the hunt for assets with higher returns than treasury bonds have been – and continue to be – a driver behind this course of events. Low interest rates have been effective, but not only in the intended manner.

The challenges facing macroprudential policy are enhanced by decisions – or the absence of decisions – in other policy areas:

- **Tax policy**, via the deduction of interest rate payments, allows households to pay even lower interest rates after tax.

- **Housing policy** has not been able to balance the rising demand for housing, particularly in the major urban areas. This has pushed house prices upward, in the process raising how much households must and can borrow to purchase a home. Construction levels have increased in recent years, but there are now concerns that it is mainly homes that are too expensive for households to buy that are being built.

The way forward

The crisis in the 1990s gave Sweden an inflation target and the insight into the importance of stable public finances. The financial crisis in 2008 came from external forces. Sweden emerged more unscathed than many other countries, in part thanks to the lessons from our own banking crisis 15 years earlier. The financial crisis has given us stricter capital and liquidity requirements on banks and resolution as a method for managing banks in crisis. This means that Sweden is now better equipped than it was before the financial crisis.

The financial crisis has also introduced a new and important policy area – macroprudential policy. Tools that establish limits for the indebtedness of individuals and amortisation requirements are important elements of a well-functioning and robust credit market. One objective of such tools is to prevent a course of events that does not fall within the responsibility of traditional policy areas or even is amplified by measures within other policy areas. It is not reasonable, however, to expect these types of measures to be able to withstand the strong forces that are causing debt to rise given the current conditions. There is a paradox here – FI is expected to squeeze so tightly that the growth of debt slows at the same time as policy in other areas pushes in the opposite direction.

The long-term target of economic policy is high and sustainable growth with low unemployment. This target – in my opinion – will be threatened if we do not realise the major risk posed to the credit market by the combination of strong growth, low interest rates after tax and low mobility in the housing market. Macroprudential policy, including the stricter amortisation requirement, is trying to mitigate the risks associated with high debt, but more is needed to handle this unique macroeconomic situation.

FI has already pointed on previous occasions to the need for *a unified policy approach* to managing household debt. A unified policy approach primarily means taking a pragmatic approach to the current framework. The situation we are experiencing now was not foreseen when the tax rules were decided and the inflation target put in place. When the framework for macroprudential policy was outlined by international bodies, few could have guessed that the new policy area would meet such big challenges.

What we have learned from various crises, however, is that no framework is perfect. And every framework needs to be managed by taking into consideration the current conditions, especially if these conditions include unforeseen characteristics. The challenge for Sweden given the conditions we are experiencing right now is to ensure that we are developing our framework in such a way as to avoid a crisis.

A broad discussion about a unified policy approach could lead to measures within several areas of policy, thus enabling us to deal with today's high indebtedness *in a timely manner*. This would also place the relatively mild regulation of the amortisation requirement into a more reasonable perspective.

It should be added that banks and other private actors also carry a significant responsibility. Many firms now have ambitious sustainability targets, which is good. These targets should naturally include a sound and sustainable supply of credit. A natural component in a sustainable credit market is that households do not to take on excessively large loans and that those with high indebtedness amortise. This was not the case before Finansinspektionen and the political system more broadly began to take action. Now, however, the amortisation requirements and the banks' new approach are pulling in the same direction: the establishment of sound amortisation behaviour.

Final comments

Macroprudential measures are not working in a vacuum. FI is responsible for raising its hand when the possibilities for fulfilling our assignment are affected by decisions in other areas of policy. We expect – and welcome – a corresponding discussion about our decisions.

As I have pointed out, I believe we are currently facing exceptional conditions when it comes to household indebtedness. In order to manage these conditions in the best way possible, it is necessary to have an open discussion about potential measures within several areas of policy (including macroprudential policy). These exceptional conditions also raise the relevance of testing new paths to achieve a more unified policy approach to counteract household debt.

The fact that the upswing in prices on homes in recent months has turned and prices have even fallen can be viewed as an advantage in this respect. Lower house prices will probably also slow the rate at which debt is growing. This can offer more time to wait and see. And more time for analysis of and reflection on greater issues.

The phrase *everyone should play their part* might be a bit cliché, but it is as good as a starting point as any when facing challenges. Through a more unified policy approach, those of us responsible for financial stability can contribute *together* to mitigate the risk of a future crisis in the Swedish economy. The broadly shared view among decision-makers that an increase in indebtedness represents a threat provides an excellent starting point for a constructive discussion, here at the Committee on Finance today and in the future.