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Consultation response regarding Finansinspektionen's requirement for liquidity coverage ratios in individual currencies and diversification of covered bonds in the liquidity buffer

The Riksbank supports Finansinspektionen's proposal regarding liquidity coverage ratio requirements in individual significant currencies. The Riksbank also supports the proposal regarding diversification of the composition of the liquidity buffer. Finansinspektionen's proposal is an important step in strengthening the banks' resilience to liquidity risks. However, the Riksbank sees no clear justification for the liquidity coverage ratios in significant currencies other than US dollars and euros to be set at 75 per cent. The Riksbank thinks that they should correspond to the international standard of 100 per cent for all significant currencies. The Riksbank also holds the view that there is a need for greater clarity and transparency regarding the banks' liquidity risks, and that the concentration limit for covered bonds should apply per currency.

Banks' liquidity and financial stability

The Riksbank has a unique capacity to create means of payment in Swedish krona and has foreign exchange reserves in several different currencies. This enables the Riksbank to act as lender of last resort in a crisis. This means that when an institution is not able to obtain means of payment in any other way it can turn to the Riksbank. However, this supply of liquidity should only be used as a last resort. It is therefore important that the banks first and foremost manage their own liquidity risks, and that the regulations are designed in a way that ensures this.

During the financial crisis in 2008, many banks around the world experienced major problems with liquidity. Central banks were forced to adopt liquidity support measures in an attempt to curb the economic crisis. One of the reasons for the problems was that several banks had taken substantial liquidity risks without sufficiently protecting themselves against these. To increase the banks' resilience and thereby reduce the likelihood of future financial crises, the Basel Committee decided after the crisis to draw up quantitative minimum standards for liquidity. In brief, these are aimed at better matching the banks' assets and liabilities, and ensuring that the banks themselves have a buffer of liquid assets. The minimum standard for short-term liquidity is called the Liquidity Coverage Ratio (LCR). The LCR, which was introduced into Sweden through an EU directive, aims to ensure that the banks have sufficient liquid assets to counteract liquidity stress in the short term. An LCR level of 100 per cent corresponds to the capacity to withstand stress for 30 days, according to the regulations.

Liquidity Coverage Ratios in individual significant currencies

The Riksbank has long considered that the Swedish banks should face LCR requirements in both Swedish krona and other significant currencies[1]. The Riksbank therefore supports Finansinspektionen's proposal to introduce LCR requirements in individual significant currencies. Sweden has a large banking system that is concentrated around a few strongly interconnected major banks. The Swedish banks use a substantial share of market funding to finance their assets, a large share of which are short-term and issued in foreign currencies. These factors make the Swedish banks particularly vulnerable to liquidity problems. It is therefore necessary to have measures to increase the resilience of the banks in this area.

Finansinspektionen has previously introduced LCR requirements in US dollars and euros in addition to the currency-aggregated requirement. However, these two currencies are not the only significant ones for the Swedish banks. Swedish krona, together with other significant currencies besides US dollars and euros, comprise more than half of the banks' stressed liquidity outflows over the 30 days that apply according to the LCR regulations. Finansinspektionen's proposal for a Liquidity Coverage Ratio in all significant currencies is therefore an important step in increasing the Swedish banks' resilience to liquidity risks.

As the Riksbank has shown earlier, there have been periods when some banks have had very low LCR levels in certain significant currencies, and sometimes for a long time.[2] There have been LCR levels below 10 per cent. This means that the bank's reserves in Swedish krona comprise only around one tenth of the cash outflows in Swedish krona that the bank is expected to have during 30 days' stress. Expressed in a different and simplified way, this means that the bank can only cover its liquidity needs in SEK for three days of stress. The Riksbank therefore supports the introduction of a quantitative minimum requirement in all significant currencies to counteract this. However, it is not clearly motivated why 75 per cent is regarded as an appropriate level, compared with 100 per cent, which is the starting point for the total Liquidity Coverage Ratio and the levels in EUR and USD, and the international standard in this field.[3] Given this, the Riksbank thinks that the starting point should be 100 per cent for all significant currencies if there is no special reason for setting a different level.

Finansinspektionen argues that liquid assets in EUR and USD can be used to cover outflows in other currencies, such as SEK, and that the Liquidity Coverage Ratio in these currencies could therefore be lower. However, the Riksbank would like to clarify that this creates a dependence on a smoothly-functioning foreign exchange swap market and on individual institutions' access to this, which has not always been possible in a crisis. Further, the consultation memorandum states that the supply of eligible assets that may be included in the liquidity buffer contributes to the assessment of a suitable level for Swedish krona. The Riksbank can here note that a bank can raise its LCR without changing the composition of its liquidity buffer, for instance by instead extending the maturities of its financing.

The Riksbank also considers that Finansinspektionen should take formal Pillar 2 decisions regarding the LCR requirements in all significant currencies. The Riksbank has earlier pointed out the problems concerning Finansinspektionen's choice not to take formal Pillar 2 decisions[4], and has the same views with regard to this proposal. Formal decisions create

[1] See, for instance, the Riksbank's report Financial Stability 2016:2.

[2] ibid.

[3] See "Basel II. The Liquidity Coverage Ratio and liquidity risk monitoring tools", Basel Committee on Banking Supervision, January 2013 and the European Commission's Delegated Regulation 2015/61, October 2014.

[4] See, for instance, the Riksbank's consultation response regarding changes in the Pillar 2 method: interest-rate risk in the bank book, 27 February 2018.

clarity both for the banks themselves and for investors assessing the banks' liquidity risks. They also bring legal clarity and reduce the risk of judicial disputes.

As the Riksbank has pointed out earlier, it is also important that Finansinspektionen ensures that there is transparency regarding the banks' liquidity risks. When there are very limited opportunities to assess a bank's liquidity risks, investors may find it difficult to determine which liquidity risks the Swedish banks are exposed to in different currencies, which may prevent them from fully pricing the risks they are taking. Several of the major Swedish banks do not currently publish any information on the size of the liquidity risks they take in individual significant currencies according to LCR. The Riksbank has been recommending since 2016 that the major Swedish banks publish their Liquidity Coverage Ratios in all significant currencies at least quarterly[5]. The banks calculate these levels daily and report them to the Riksbank. As the banks are to meet the requirements for liquidity coverage at each given point in time, it is also important for the market to know how the banks relate to this requirement.

Diversification of covered bonds in the liquidity buffer

The Riksbank supports Finansinspektionen's proposal regarding diversification of the composition of the liquidity buffer. The Riksbank has regularly in its publications drawn attention to the risks entailed in the Swedish banking sector's high level of concentration and cross-ownership of covered bonds. More distinct requirements for diversification would therefore be beneficial for the Swedish banks' resilience and for financial stability.

However, the current proposal only contains a limit for the aggregate level, that is, that a maximum of 50 per cent of the currency-aggregated liquidity buffer may consist of covered bonds from Swedish issuers. If a bank has several significant currencies, it is reasonable to have a limit per currency. Otherwise the banks' liquidity buffers in individual significant currencies, such as Swedish krona, may become strongly dependent on the market for covered bonds even when the bank can meet the requirement on the aggregate level. The Riksbank therefore considers that the limit should apply per currency.

On behalf of the Executive Board:

Cecilia Skingsley

Emelie Nilsson

Taking part in the decision: Stefan Ingves, Kerstin af Jochnick, Per Jansson, Martin Flodén, Henry Ohlsson and Cecilia Skingsley.

The reporter was economist Nathalie Gibas Hjertquist.

[5] See, for instance, the Riksbank's report Financial Stability 2016:2.