

2016-03-11

Basel Committee on Banking  
Supervision

## **Revisions to the Standardised Approach for credit risk - second consultation**

### **Summary**

- According to the proposal the revised standardised approach (SA) will going forward not only be the basis for determining capital requirements for banks not eligible to use internal models but also serve as a reference point for disclosure and for capital floors for those banks that are allowed to use internal models for determining capital requirements. This can only work - in a meaningful sense - if there is an unambiguous relationship between the SA risk weights and the actual risk of loss. We believe this is impossible to achieve as long as the Basel committee holds on to its ambitions to keep the SA as a very simple, highly standardised one-size-fits-all approach for setting risk weights for credit risks.
- We strongly recommend that a risk-based approach founded on internal models also in the future will be the basis for determining capital requirements for large banks
- Since *residential real estate* markets are very different in different countries it is not appropriate to globally harmonise risk weights. A single risk indicator such as loan to value (LTV) may be useful to compare the risk levels within a country but is far too blunt to compare risk levels between banks in different countries. National flexibility and calibration is necessary.
- To use *value at origination* for calculating LTV will be misleading. LTV can only be relevant as a risk indicator if it is calculated on the basis of the property's current value.
- *Tranching* of real estate exposures across different LTV buckets should be allowed
- For *corporate exposures* we support the use of external ratings. However, the risk weight for investment grade corporates is too high and should be lowered to at least 75 per cent.
- *Exposures to covered bonds*, that are issued and governed by specific legislation, should have a preferential treatment.

## General comments

### **The proposed SA will not work as a relevant and reliable base for capital floors**

The Basel Committee is proposing an extended scope for the standardised approach for credit risk (SA). The revised SA will onwards not only be the capital requirement method for banks that do not use internal models, but also serve as a reference point for disclosure and for "capital floors" (or probably more adequate: risk weight floors) for IRB banks. This would only be appropriate if there is an unambiguous relationship between the SA risk weights and the actual risk of loss in different exposure classes. We believe that this is impossible to achieve as long as the Basel Committee holds on to its other ambitions, i.e. that the SA should be very simple and rest upon global standardisation.

If a revised SA for credit risk is to be used as a reference point for disclosure and a base for capital or risk weight floors we believe that it is essential to leave room for national flexibility and calibration, within a globally controlled framework. We strongly oppose a one-size-fits-all model that uses the same risk drivers and the same calibration for banks all over the world. For instance, creditor protection is extremely strong in the Nordic countries and foreclosure processes are efficient which is reflected in historically very low losses on mortgage lending.

We strongly recommend that a risk-based approach founded on internal models also in the future will be the basis for determining capital requirements for large banks. Risk sensitivity is essential and internal models remain imperative in building awareness and understanding of risks both within banks and among supervisors. Internal models are also, given the availability of sufficient data, the best measure for reflecting the true risk of a bank's portfolio of exposures, and therefore allocating adequate levels of capital against these risks.

We believe that refining the internal ratings-based (IRB) approach is a far more fruitful method to achieve the objectives of the Basel Committee than to use a revised SA as a base for capital floors. The European Banking Authority (EBA) has already suggested a number of measures to address potential shortcomings in internal models and to make sure the internal models are implemented in a coherent way across jurisdictions and banks within Europe. In our view, this is the right way forward towards the goals of high confidence and increased comparability that the Basel Committee wants to achieve.

Looking at the proposal for a revised SA for credit risk as a stand-alone proposal (i.e. not as a reference point for disclosure and capital/risk weight floors) we can't see any urgent need for change. Most European banks that today use the standardised approach are small or medium-sized and focus on retail lending. For these banks the

proposal will add complexity and compliance costs, without necessarily strengthening the risk sensitivity or the measurement and control of risk.

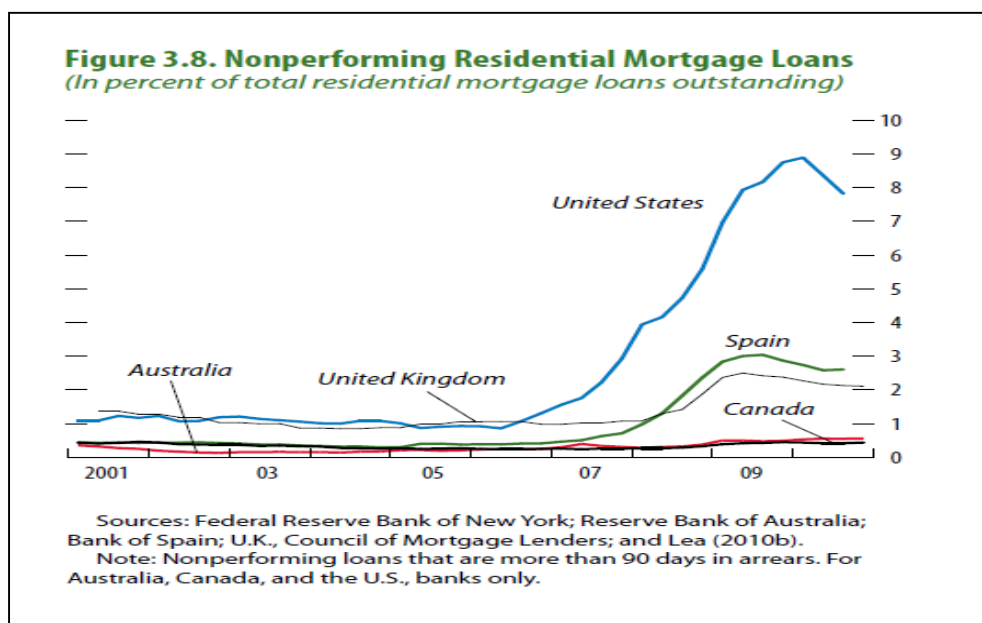
In the forthcoming sections we comment on the issues that from a Swedish perspective are the most important in the consultative document.

## Comments on specific parts of the proposal

### Real estate exposures

#### *General comments*

One of the major drawbacks for using risk weights calculated according to the revised standardised approach is that the asset categories proposed in the new SA framework are not homogenous from a risk perspective. This is quite obvious for the asset category residential real estate where historical loan losses vary significantly between different jurisdictions as illustrated in the graph below (copied from the IMF April 2011 Financial Stability Report) .



The differences between the chosen jurisdictions are striking and it is hard to believe that they can be explained by systematic differences in loan to value (LTV) between the countries. A part of the variation could probably be explained by differences in the development of the business cycle between the jurisdictions but most likely other factors, such as local business practices and local legislation, are far more important. Important factors neglected by the Basel Committee are, inter alia, to what extent the borrower is liable for the remaining debt if the collateral is sold, the social welfare

system, the legal efficiency when it comes to realize the collateral or to what extent residential mortgages are combined with special guarantees or insurances, maybe with some kind of government backing etc.

Our conclusion is therefore that it is neither possible nor appropriate to globally harmonise a detailed system for risk weights for residential real estate. To use a single risk indicator such as the LTV might work to compare the risk level between banks within a country but is far too blunt to differentiate the risk of banks' mortgage loan portfolios in different countries, especially if national calibration of risk weights is not allowed.

*LTV should be based on the current market value*

According to the consultation document the property value used to calculate the LTV should as a main rule be the value measured at origination. In the instructions for the Basel monitoring exercise the definition of "value at origination" is clarified by the sentence "If after the initial origination of the loan, the borrower has applied for an increase of the loan size and the originating bank, after a credit review including a new valuation, has approved this increase in loan size, the valuation at the time of the increase in loan size should be used when calculating LTV for the exposures collateralised by the property".

Since the price of real estate changes through time, the use of a property's value at origination when calculating LTVs will make the measure less and less relevant, as an indicator of the risk of loss, the more time elapses since the loan was originated.

**Example**

*Three similar houses are situated on the same street. The current market value of the properties is 1,000,000 Euro for each.*

*There is a mortgage currently amounting to 390,000 Euro on each house.*

*The mortgages are "originated" at different points in time (depending on for example when the house was acquired or if the borrower has switched from one bank to another) and the value at origination is thus diverging between the houses:*

*House 1: Value at origination 460,000 Euro => SA LTV=85% SA RW= 45%*

*House 2: Value at origination 550,000 Euro => SA LTV=71% SA RW= 35%*

*House 3: Value at origination 1,000,000 Euro => SA LTV=39% SA RW= 25%*

*The conclusion is that identical houses with the same amount of mortgage can get significantly different risk weights if the calculation of LTV is based on value at origination instead of current market value.*

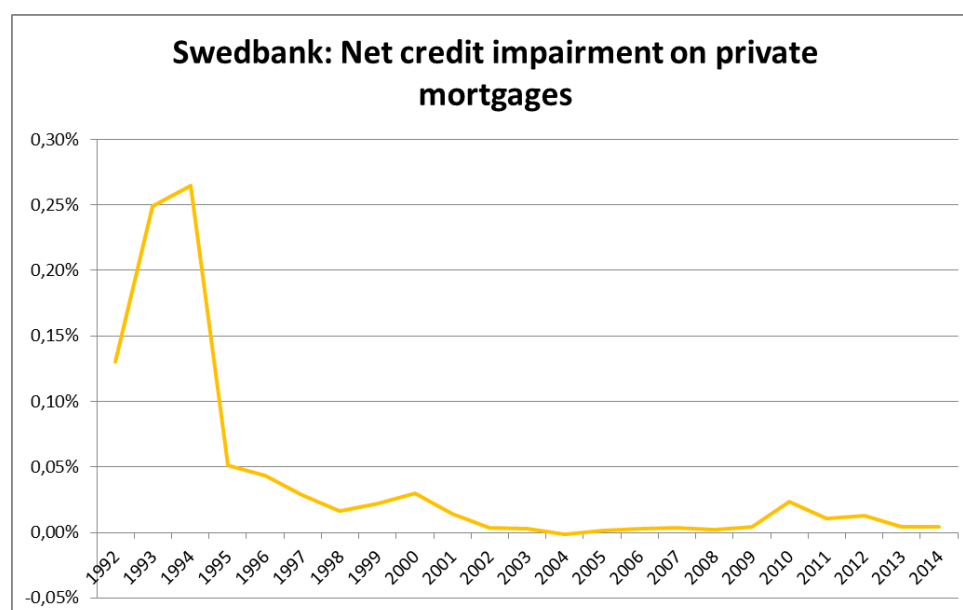
In our view LTVs could only be relevant as a risk indicator if they are calculated on the basis of a property's current value. However since loan losses on real estate

varies between markets far more than can reasonably be explained by differences in LTV levels, calculating LTVs on the basis of the current market value of a property will not be enough for arriving at relevant risk weights. In addition it is also necessary that the risk weights associated with a particular LTV-level are locally calibrated based on the particular circumstances on the local market.

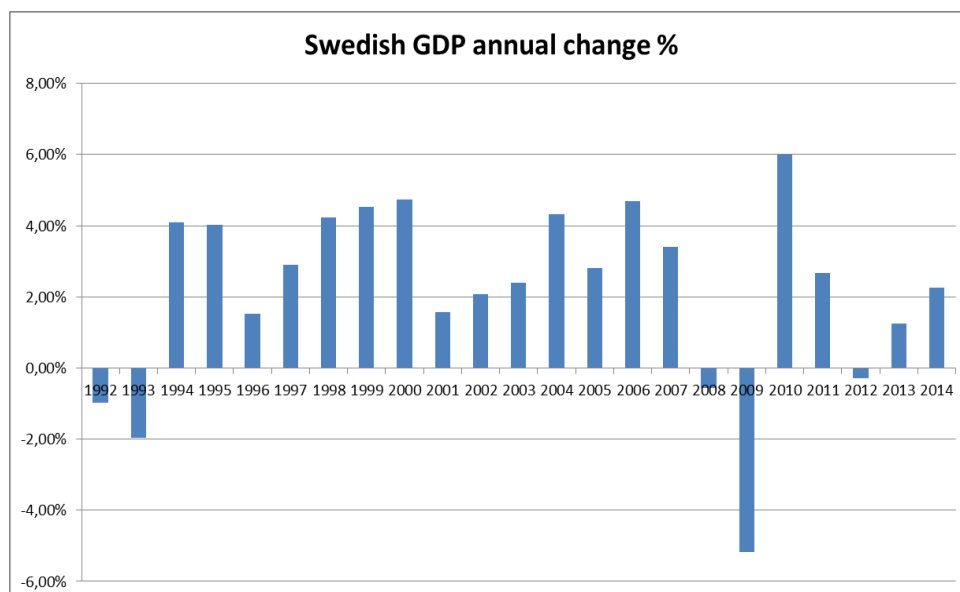
*The proposed risk weights for residential real estate are too high*

In particular we deem that the risk weights for residential mortgages proposed by the Basel Committee are far too high to be relevant in a Swedish context.

In Sweden annual reported credit losses on residential properties has historically been minimal. The loan losses displayed in the chart below is representative for Swedish mortgage lenders. It shows loan losses on owner occupied dwellings during the period 1992-2014 in Swedbank, one of the major Swedish mortgage lenders with a market share that has fluctuated around 25%-30% during the period. As can be seen in the graph the loan losses varied between 0.26% and slightly below 0% of the outstanding loan balance during the period.



During this time period Sweden went through two severe recessions, one during the period 1991-1993 and another one during 2008-2009. In addition there was also a minor setback in 2012 as can be seen in the graph below.



During the first recession in the early 1990 average prices on residential properties fell by around 20% whereas they remained stable during the second downturn.

Since interest rate margins on mortgages in residential properties have varied around 1% during the whole period displayed in the charts one can conclude that in neither of the two severe recessions did annual loan losses on residential mortgages amount to more than a couple of months' net interest income earned by the mortgage portfolio. Hence no part of the mortgage lenders' capital was needed to cover loan losses on residential mortgages during the period covered by the charts. See also Appendix 1 for more information on the development in the Swedish housing market.

#### *Tranching of loans should be allowed*

According to the revised SA proposal "risk weights would have to be applied to the full exposure amount (ie without splitting the exposure across different LTV buckets)". This view seems to rest on an assumption that mortgage collateral always is created by a direct pledge of the property. In Sweden mortgage collateral is instead based on special mortgage certificates (Pantbrev) which makes it far more relevant to split exposures across different LTV buckets.

Mortgage certificates are issued by the Swedish Land Registry. The certificate proves that the Land Registry have registered a specified nominal amount as a potential encumbrance over the property. This certificate will then allow the property owner to pledge the property without further engagement from the Land Registry or any other public authority. To make the pledge effective the mortgage certificate has to be handed over to the lender.

It is essential to note that the pledge does not cover the property as a whole, only the part of its value represented by the mortgage certificate. The mortgage certificate entitles, if pledged and handed over to a creditor as collateral for a liability, the creditor to require a forced sale of the property, if the borrower does not honour his debt, and to claim an amount from the proceeds of the forced sale, not exceeding the nominal amount specified in the certificate plus some smaller, well defined, additions.

In the Swedish system it is hence not possible to pledge the entire property as such – the pledge must always be in respect of one or more specified mortgage certificates. Neither is it possible to create a “second lien” over the property as such, only over one or more specified mortgage certificates. The value of a mortgage certificate as collateral is usually described by referring to its nominal amount as being placed “within” the aggregated nominal amount of itself and all other mortgage certificates with a better ranking. If for example the nominal amount of a mortgage certificate would be 100,000 and there would be two better ranking certificates, one with a nominal amount of 200,000 and one with a nominal amount of 300,000, the 100,000 certificate would be referred to as a mortgage certificate of “100,000 within 600,000”.

The systems for pledging real estate collateral in Finland is similar to the Swedish system. With these kinds of mortgage pledging systems tranching of loans into different LTV buckets gives a far more relevant view when describing the LTV structure of a loan portfolio than the approach suggested in the SA proposal. This is so because it is not unusual that a particular loan is secured by a mortgage certificate which sits in one particular LTV-tranche, e.g. in the LTV tranche 30%-40%. According to our view such a loan has a risk profile that diverges from a loan secured by a mortgage certificate in the LTV tranche 0%-40%. Splitting the exposure across different LTV buckets when determining the risk weight, will take this difference into account and is thus preferable in comparison to the approach proposed by the Basel Committee. This approach will also give a relevant view if it is the property in itself instead of a mortgage certificate that is pledged as collateral. This is thus a more generic approach than the one proposed by the Committee.

An additional and significant benefit with tranching is that cliff effects can be avoided. With tranching a small increase of the loan amount pushing the LTV into a higher LTV bucket, the corresponding higher risk weight will only apply to the part of the loan that falls in the higher LTV bucket instead of being applied on the full loan amount.

*Repayments materially dependent on cash flows generated by the property*

Higher risk weights are proposed for the situation when the borrower's repayment capacity is, from a formal point of view, materially dependent on the cash flow generated by the property.

In our view this provision must be applied in a proportionate and non-formalistic way. For instance in Sweden large real estate companies' ownership of properties is commonly structured so that separate legal entities own each individual property. Loans to each of these separate companies could in theory be classified as income producing real estate although the properties owned by such legal entities are from a practical point of view a part of a larger portfolio of properties, and loans to one of the real estate owning entities are usually in addition to the real estate collateral also usually backed with a guarantee from the parent company. It is important that legal structures can be looked through in this respect, and that several legal entities within one group structure can be seen as one entity. This can be achieved by noting that guarantees within a group should imply that the repayment capacity is not materially dependent on a specific property.

### **Corporate exposures**

*We support the use of external ratings*

Corporate exposures will be split into exposures secured by real estate, specialised lending and other corporate exposures. The major part of the Swedish banking sector's corporate exposures will fall into the real estate category and the other corporate exposure category.

The drawbacks with using LTVs based on property values at loan origination will be similar for commercial real estate as for residential real estate. The protective value of real estate collateral varies between jurisdictions and the market value of real estate changes through time. Using LTVs calculated in accordance with the proposal will hence neither be relevant when comparing the credit quality of loan portfolios secured by collateral in commercial real estate nor as a reference point for risk weight floors.

When it comes to other corporate exposures the Basel Committee has chosen to use external ratings for rated enterprises when determining the risk weight. This seems to be an adequate approach when developing a reference point intended to be used globally, since external ratings aim at taking the particular circumstances of the rated firm and its jurisdiction into account in its rating process.

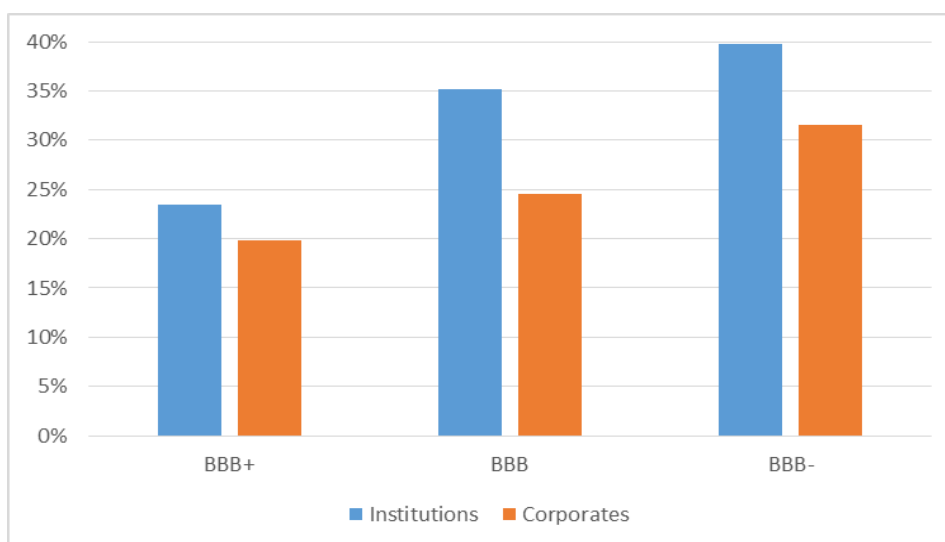
*100% is a too high risk weight for investment grade*

We are of the opinion that a 100% risk weight for exposures to BBB (investment grade) rated corporates is far too high and should be lowered. Having a risk weight for BBB-rated corporates which are twice as high as that of A-rated corporates and the same as that of BB-rated corporates is definitely not in line with the risk profile of such exposures. Our view is that the dividing line in terms of credit quality goes between investment grade and non-investment grade, e.g. between BBB and BB.

Our proposal is that the risk weight for BBB-rated corporate exposures should be lowered to at least 75%, which is in line with the risk weight for "investment grade" corporates in jurisdictions that do not allow the use of external ratings for regulatory purposes. From a credit quality perspective it is even realistic to lower the risk weight for investment grade corporate exposures even further, see example below.

**Example**

*The figure below shows the risk weights for exposures to institutions (banks) and to corporates, for different risk classes in a large Swedish banks. As shown, corporates have lower risk weights in the rating bucket (BBB+-BBB-) that have 100% risk weight for corporates and 50% risk weights for banks. The data strengthens the position that the risk weight for BBB-rated corporates are too high.*



*Uniform risk weights applied on all corporate exposures lacking an external rating will not be adequate if the standardised approach should serve as a benchmark for risk disclosure and capital floors.*

Regarding exposures to corporates lacking an external rating the risk weight will be 100% unless the annual turnover of the firm is lower than 50 million Euro. Then the risk weight will be 85%. These risk weights will apply regardless of the firm's domicile

or in what industry it is operating in, although the risk of loss varies significantly between industries and also may vary significantly depending on in what country a borrower is domiciled. Since the 100% or 85% risk weights will be applied on the major part of most banks' corporate loan books regardless of the quality of the exposures, it will make the SA risk weight irrelevant when assessing or comparing the risk level of most banks' corporate loan books.

It's interesting to note the change of view between the first and this second consultative document when it comes to the relationship between turnovers (or revenue as it is called in the first document) and risk for a particular corporate counterparty. In the first proposal, the level of revenue was supposed to be correlated negatively with the level of risk, with higher turnover leading to lower risk-weights. In this proposal, it's the other way around. There are arguments in both directions, so the change is to some degree understandable. But the issue illustrates very clearly the difficulties in addressing risk with one or a few single indicators, which should reflect all circumstances globally. This is one of two indicators that have been on the table, and it is not even possible to determine the direction of it.

In Sweden, and the Nordic and Baltic countries where the Swedish banks operate, there is a systematic variation in loan losses on corporate loans depending on the kind of business the enterprise is active in. E.g. losses are in general higher in industries where it is easy to dispose assets, such as retail, whereas they are lower in industries where assets are immovable, such as forestry and farming. In addition there could be significant variations in the credit quality between individual firms and systematic variations between the credit quality of corporates from different jurisdictions depending on local business practices, legislations and to what extent the rule of law applies. It is hence not very likely that the uniform SA risk weights that are supposed to be applied worldwide will provide reliable information about the credit quality of individual banks' corporate loan books.

### **Retail exposures**

Retail exposures will, according to the revised SA, be split into ordinary retail and other retail exposures. The dominating part of the retail exposures will in Sweden be classified as ordinary and receive a 75% risk weight. Other retail exposures will receive a 100% risk weight. Loan losses on retail exposures are highly dependent on local traditions, legislation and the social and private security safety nets that protect households and will thus vary significantly between jurisdictions. Applying one and the same set of risk weights on retail exposures regardless of how local household safety nets are set up and performing will hence not promote transparency about banks' exposure to retail credit risk. Losses on retail exposures have always been low and stable in Sweden and the other Nordic countries. This is because the region consists of strong and stable societies with very strong private as well as social

safety nets. Taking this into account the risk weights proposed in the revised SA are far too high to be applied in this region.

## **Exposures to banks**

### *Covered bonds*

We are of the opinion that covered bonds, issued and governed by specific legislation, should have preferential risk weight treatment since there are specific collateral behind the covered bond, which are circumvented with very high safety margins and strict rules in order to make sure that there are sufficient collateral in place in case of a failure of the issuing bank. In Sweden, and in many other countries, the covered bond market has performed very well even in stressed situations. It has never been reported any credit losses from exposures to covered bonds, anywhere. Further, covered bonds are particularly important for banks as they are eligible for being included in a bank's liquidity reserve in respect of prudential liquidity requirements (LCR). Therefore it is important that the costs of carrying large liquidity reserves are not unduly high.

## **Currency mismatch**

According to the consultation document an add-on to the risk weight for corporate, retail and real estate will be applied for exposures where there are currency mismatch. Banks should apply a 50% risk weight add-on to "unhedged exposures" with currency mismatch. "Unhedged exposure" is defined as "an exposure to a borrower that has no natural or financial hedge against the foreign exchange risk resulting from the currency mismatch between the currency of the loan and the currency applied to pay down the loan".

We believe that the proposed add-on is not appropriate due to that fact that such credit risk is already incorporated as part of the external rating and due diligence requirements. The proposed rule will lead to double counting of such risk.

Furthermore, we would like to point out that the proposal may have strange and unreasonable effects for exposures to large international corporates. Such corporates can earn most of their income in e.g. Euro or US dollar and at the same time have loans in many different currencies. At least when the size of the "mismatched loan" is small compared to the total size of the company we can see no reason for an add-on.

### *Currency mismatches hedged by residential properties*

As EU/EES integrates it becomes increasingly common that EU households own a property situated in a country with another currency than the currency of the household's income. This could for instance be the case with families living close to

borders between countries in EU/EES with different currencies and having their home on one side of the border and earning their income on the other side. Another example is when families have a vacation house in another country than in that were it earns its income. In several of these cases it is common that if the property is financed with a mortgage loan, that loan is denominated in the same currency as that of the country where the property is situated. This practice has developed because the financing banks deem it is too risky to provide a mortgage loan in a different currency than the currency of the country where the property is situated. This is because history tells us that from time to time exchange rates may change significantly within a short time period without having much impact on property prices.

In order not to punish banks from applying this from a risk management sound principle the add-on for loans denominated in another currency than that of the borrower's income should not be applied on mortgage loans where the loan is in the same currency as that of the country where the property taken as collateral is situated. We therefore propose that the wording of paragraph 63 in the SA proposal is changed in the following way:

*63. For the purposes of paragraph [62], unhedged exposure means an exposure to a borrower that has no natural or financial hedge against the foreign exchange risk resulting from the currency mismatch between the currency of the loan and the currency applied to pay down the loan. A natural hedge exists where the borrower, in its normal operating procedures, receives foreign currency income that matches the currency of a given loan (eg remittances/export receipts) or if the exposure is secured with a property situated in the country having the currency of the loan as its national currency. A financial hedge generally includes a legal contract with a financial institution (eg forward contract).*

## **Defaulted exposures**

### *Acquired defaulted exposures*

The risk weights of defaulted exposures are proposed to be increased due to a perceived double benefit for the current risk weight (lower exposure amount and lower risk weight). The guiding principle for which a risk weight is correct for an asset is the inherent risk in the cash flow. Assets with less certain cash flows should have higher risk weights and vice versa.

Our view is that there is no double benefit in the current risk weight, due to the effective write down, in acquired defaulted exposures. Trades of defaulted exposures are done on a relatively active market, typically in auction like settings. Acquirers are often, but not always, non-regulated debt collection companies. The net booked value of defaulted exposures include the value of the asset, as well as an acquisition margin and the effective write-down.

$$\text{Nominal amount} = \text{Asset value} + \text{acquisition margin} + \text{effective write down}$$

Is there a difference in risk between performing credits and acquired defaulted exposures? Thorsell<sup>1</sup> finds that there is an excess return on defaulted corporate bonds, meaning that a portfolio of corporate bonds, after re-valuation have a higher return than can be explained by their riskiness. This means that defaulted corporate bonds typically trade at a discount, and is less risky than could be expected. Furthermore, the difference in market beta between ex-post non-defaulted bonds and defaulted bonds are insignificant in the GARCH (1,1) specification (0.0855 vs 0.0843).<sup>2</sup> This means that the asset quality for an acquired defaulted exposure is similar to a corporate credit, and should have a similar risk weight.

The threshold level of at least 20% in provision, write down or acquisition margin for a lower risk weight (100% instead of 150%) in the current standardised approach for credit risk can still be relevant as a threshold level for acquired defaulted exposures meaning that the Asset value in above formula can be maximum 80% of the Nominal amount, since that is an indicator of a sound buffer for unexpected losses.

We suggest that an article is added after paragraph 76:

xx. Acquired defaulted exposures where the asset value (net booked value) is equal to or lower than 80% of the remaining nominal exposure amount shall be risk-weighted at 100%.

We suggest that paragraph 77 is changed to:

77. With the exception of acquired defaulted exposures under paragraph [xx] and real estate exposures treated under paragraph [78], the unsecured or unguaranteed portion of a defaulted exposure shall be risk-weighted net of specific provisions and partial write-offs at 150%.

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<sup>1</sup> Thorsell, H. "The Pricing of Corporate Bonds and Determinants of Financial Structure." PhD Dissertation, EFI, Stockholm School of Economics, 2008

<sup>2</sup> The GARCH (1,1) specification is the relevant comparison since it lessens the impact on the estimate from the default itself.

**Off-Balance exposures**

Paragraph 69 is not clear in relation the description in 1.7.1 Unconditionally cancellable commitments (UCC). The Committee propose that retail commitments should be applied with 10%-20% CCF. The Committee gives credit card commitments as example. In paragraph 69 two different conditions are specified: cancelation without prior notification and effective automatic cancelation due to borrower's creditworthiness. There is a specification in footnote 56 that is somewhat unclear. In the light of the description in 1.7.1 we interpret that retail commitments (e.g. credit card) can be classified for 10%-20% CCF also in countries where the consumer protection legislation requires a prior notification to be sent to the borrower.

We suggest that the footnote 56 is changed to:

*<sup>56</sup> In certain countries, retail commitments are considered unconditionally cancellable if the terms permit the bank to cancel them to the full extent allowable under consumer protection, even with prior notification, and related legislation.*

Furthermore, based on experience of Swedish banks, we believe that credit card commitments should have a 10% CCF and not 20%.

SWEDISH BANKERS' ASSOCIATION

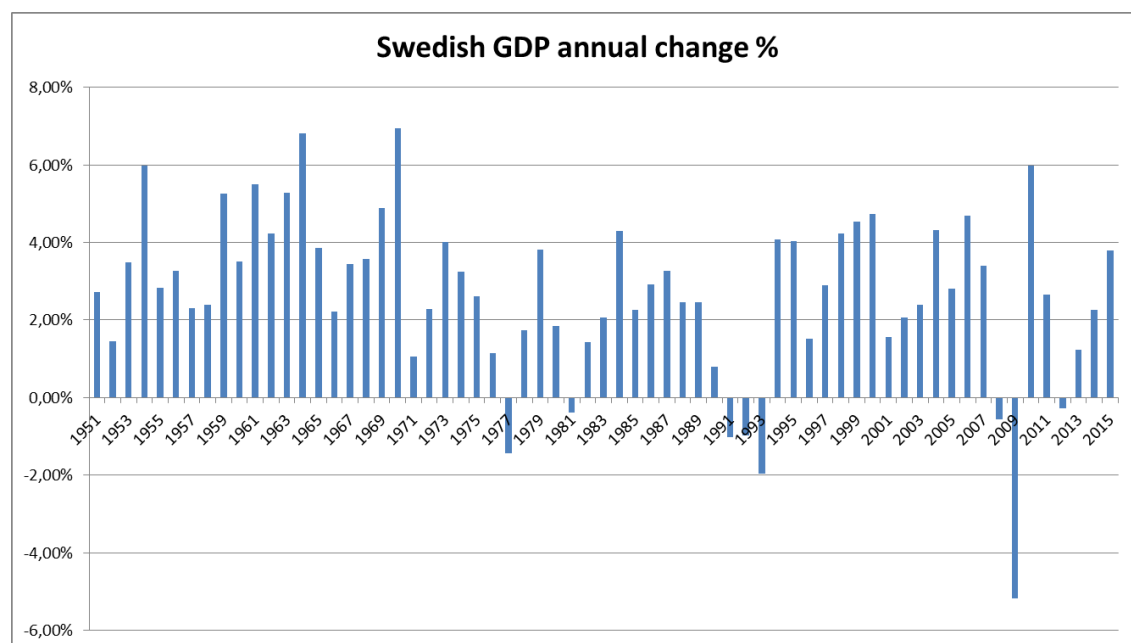
Hans Lindberg

Maria Nilsson

## Appendix 1

### Developments on the Swedish housing market

During the period after 1950 Sweden have only experienced negative growth in GDP during five periods as displayed in the chart below.



During the setback in the early 1990s the price of Swedish residential properties fell on average by around 20%. Although annual credit losses on residential properties increased significantly (by several 100 per cent) they were still minimal and only amounted to around a couple of months' net interest income on the outstanding stock of mortgage loans when they peaked in 1993.

Apart from this short period there have not been any, in relation to the outstanding loan amount, significant credit losses on residential mortgages in Sweden during the period after 1950. (Due to shortage of data and diminishing relevance we have not analysed the period before 1950.)

Taking this information into account it does not seem reasonable that Swedish residential mortgages should carry risk weights of the magnitude 30% - 40% in the standardised approach.

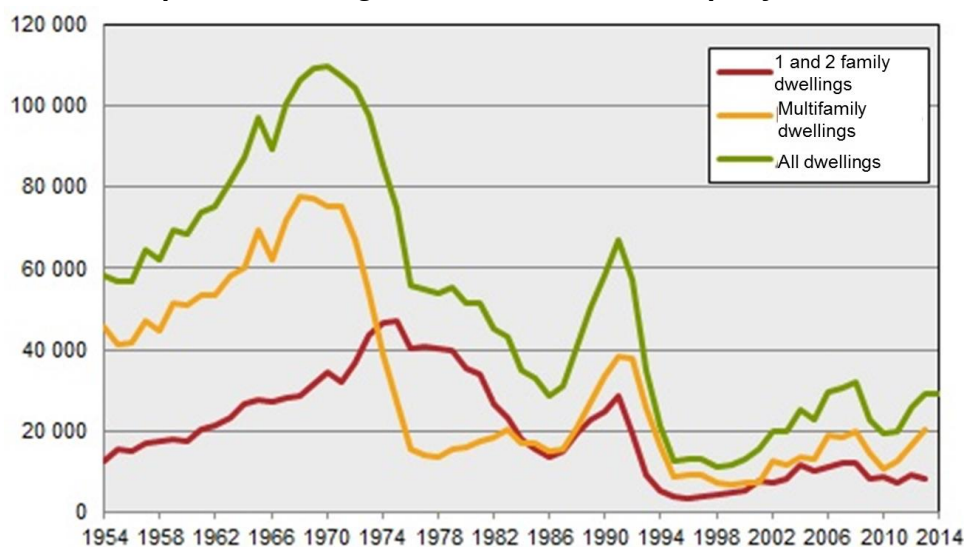
Sweden has experienced significant increases in the value of residential properties after the set back in the early 1990s and household debt has increased in parallel. This development triggers on and off speculations about whether Sweden currently is experiencing a bubble in the price levels of dwellings. Swedish banks and Swedish

authorities are monitoring the development carefully, but so far the general conclusion is that the development primarily is driven by a persistent shortage of dwellings in the expanding regions of Sweden and not by speculation. The shortage of dwellings is caused by structural changes in the Swedish housing markets and the authorities are now discussing different measures that may improve the situation. It seems however likely that the shortage of dwellings will remain for a long time and only disappear gradually.

During the period before the Swedish recession in the early 1990s the residential property market in Sweden was booming with ample construction of new dwellings. Construction work were stimulated by significant government subsidies.

The subsidies related to construction of new dwellings was almost removed within a couple of years after the crisis and as a result of this and falling prices the construction of new dwellings fell significantly and have so far not returned to the levels that occurred before the crisis.

**Chart: Completed dwellings in Sweden thousands per year 1954 - 2014**



Källa: SCB

In parallel to this drop in construction Sweden has experienced a significant population increase, primarily due to high immigration, and a significant expansion of the population to the larger cities. As a result of this development the country is experiencing an increasing shortage of dwellings in the expanding regions which in combination with the current low interest rate environment is driving Swedish real estate prices higher and higher.

In parallel with this development household debt has also increased significantly in part because some households are increasing the mortgages on their current

dwellings but also – and more important - because when properties are sold the buyer usually needs to borrow significantly more than the remaining debt that the seller might have had on the property.

In the wake of this development there has for several years been an ongoing discussion about whether a real estate bubble that may cause a subsequent real estate crash is emerging in Sweden. The research performed on this topic so far indicates that the major part of the indebted households has significant wealth and income margins that they could use to mitigate their situation if interest rates were hiked and/or if property values dropped. The conclusion drawn by the Swedish government, the Swedish FSA and the Riksbank is therefore that even if there was a jump in interest rates and a severe drop in real estate prices the impact will primarily be a drop in household consumption that may create problems for the corporate sector and increasing unemployment, however credit losses on mortgages are likely to remain low.

The Swedish authorities are now discussing - and taking - actions aiming at reducing the probability of this kind of negative development to occur. The measures taken so far include actions aiming at stimulating the construction of new dwellings and to damper the build-up of household debt. The latter set of macro prudential actions include a cap on LTV ratios for new mortgage loans at 85%, explicit amortisation requirements on all mortgage loans having LTVs above 50% and a 25% risk weight floor on residential mortgages. In this context it is worth mentioning that the Swedish FSA first prescribed a risk weight floor for mortgages at 15% and then later increased the floor to 25%. According to the Swedish FSA the purpose with the 15% floor was to build capital buffers aiming at mitigating credit losses on residential mortgages whereas the purpose with the subsequent increase to 25% was primarily aiming at in a more general way mitigate the risk of building up a situation that may result in a more general negative development of the Swedish economy. The current risk weight floor on residential properties should hence not be taken as a confirmation that the general risk in the Swedish market for residential mortgages is perceived to be such that a permanent risk weight floor of the magnitude 25% or higher is needed. The current risk weight floor should rather be regarded as one of several macro prudential actions aiming at avoiding building up an unstable situation in the broader economy.

To conclude: Neither the Swedish experience of losses on residential mortgages nor the analyses performed by the Swedish authorities of the current status of the Swedish residential mortgage loan portfolios, indicates that risk weight floors above 15% are motivated from a pure credit risk perspective. Applying a 15% floor on Swedish mortgages will create quite a significant capital buffer in comparison to the minimal losses on residential mortgages experienced in Sweden so far.