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Consultation response to the report on the Riksbank's financial independence and balance sheet

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Summary

General starting-points

The Riksbank welcomes the fact that the Riksbank's financial independence and balance sheet are the subject of further inquiry. Financial independence means that the Riksbank has adequate financial resources to carry out its tasks independently. The starting point for this consultation response is that the Riksbank wishes to contribute to a clear system and robust processes for how the size of the Riksbank's equity and foreign currency reserve shall be determined. Flexibility is also required with regard to the size of the amounts so that the Riksbank can maintain liquidity supply in a crisis and so that the bank can independently carry out its tasks.

The size of the Riksbank's equity should reflect the risks on the balance sheet now and in the future. These risks vary substantially over time, which the legislation should take into account. The risks arise as a result of both policy measures and financial price fluctuations. One example is the expansionary monetary policy conducted in recent years, where purchases of government bonds to safeguard the upturn in inflation have increased the risks in the Riksbank's balance sheet. Larger changes in interest rates, exchange rates and the price of gold also have major effects on the Riksbank's profits and on the size of the equity.

The Riksbank holds a currency reserve to be able to contribute to a stable financial system and influence the Swedish krona for monetary policy purposes. A pre-financed currency reserve can also prevent a financial crisis by creating confidence in the Riksbank's ability to take action in a crisis that threatened the Swedish credit and payment system. Funding the currency reserve only once a crisis has occurred is problematic. In such a situation, funding can be more expensive, take longer time to implement and affect the impact of monetary policy.

The currency reserve should be of sufficient scope to cover the needs that can be expected to arise in the short term in a financial crisis. Sweden has a large and growing cross-border banking sector with considerable commitments in foreign currencies, which entails significant risks to financial stability and ultimately to the national economy. The Swedish banking *system's total balance sheet corresponds to four times Sweden's GDP. The four major banking groups alone have liabilities in foreign currency amounting to 175 per cent of Sweden's GDP. Both the Riksbank and the IMF assess that the Riksbank's currency reserve should not be reduced from the current level.*

The currency reserve is currently financed partly through the Swedish National Debt Office borrowing foreign currency on behalf of the Riksbank. When the borrowing decisions were taken, both the Riksbank and the Swedish National Debt Office considered this to be the most cost-efficient way of strengthening the currency reserve. The funding cost of the borrowed part of the currency reserve is reduced by funds being invested in interest-bearing assets. The costs that nevertheless arise are to be regarded as an insurance premium. The currency reserve reduces the risk of a crisis and ensures good protection when a crisis actually occurs. The cost of the pre-financed borrowed part of the currency reserve could preferably be funded by banks that create liquidity risks in foreign currency.

The Riksbank understands that it cannot have unconditional drawing rights on the borrowing in the name of the Swedish National Debt Office. It is therefore reasonable that the Debt Office, within the scope of its mandate, finds a balance between the Riksbank's need of an appropriate currency reserve and other public sector needs via the central government budget. The Riksbank can instead – unless the Swedish National Debt Office considers that the borrowing should take place via the Swedish National Debt Office – use the option of either purchasing foreign currency against payment in Swedish kronor or borrowing foreign currency in order to strengthen the currency reserve.

The currency reserve will in the future still amount to its current size and there are several alternatives to achieve this. However, the Riksbank considers borrowing via the Swedish National Debt Office to still be the most efficient way of financing it at present. One way of making all methods equally cost-efficient is for the banks that create liquidity risks in foreign currency to pay the insurance premium which the various methods entail.

The Riksbank's assessment of the proposals in the draft referral to the Council on Legislation

The Riksbank supports the proposal for a profit distribution model. By the Riksbank retaining its statutory right to make allocations for financial risks, the proposal complies with EU legislation rules on financially-independent central banks.

According to the current provisions in the Sveriges Riksbank Act, the Riksbank has the right to make a request to the Riksdag for a capital injection regardless of the level of the Riksbank's equity. It is assumed that this right will be left unchanged. Otherwise, the proposal on recapitalisation contravenes the principle of the central banks' financial independence.

The Riksbank opposes the Inquiry's proposal to limit the Riksbank's right to reinforce the Bank's currency reserve by borrowing via the Swedish National Debt Office. Even if the Riksbank is able to fund the currency reserve in its own name, the most cost-efficient solution appears to be for the Swedish National Debt Office to continue to borrow on behalf of the Riksbank. However, the Riksbank should not have the right to unlimitedly and unilaterally decide on borrowing from the Swedish National Debt Office. The current system, which entails the Swedish National Debt Office having to make a government debt policy deliberation within the framework of its mandate, should be clarified in the text of the law.

The Riksbank also opposes the proposal to reduce the currency reserve through repayment to the Swedish National Debt Office, as the Riksbank, like the IMF, considers that the current level of the currency reserve should not be any lower. Furthermore, it is desirable to have a longer transition period if the loan from the Swedish National Debt Office is nevertheless to be repaid. For instance, one could allow the loan on the Riksbank's balance sheet to mature to reduce the costs and risks of an overly rapid reallocation of the Riksbank's foreign assets. A repayment in contravention of the agreement between the Swedish National Debt Office and the Riksbank is moreover not compatible with the regulations on the Riksbank's independence.

Imposing an insurance premium on banks that create currency risks would be an appropriate way of solving the currently perceived problems of a pre-financed currency reserve, and the Riksbank proposes that this option be investigated as soon as possible.

1. The Riksbank's need of equity (Section 5.1)

The Riksbank supports the proposed dividend payment threshold (the targeted equity) of SEK 60 billion.

The Riksbank's dividend payments follow the guidelines established by the General Council of the Riksbank in 1988 and approved by the Riksdag the following year. These guidelines state that the Riksbank shall every year transfer 80 per cent of its surplus to the Treasury. The remaining 20 per cent is to be used to build up equity. The surplus is determined as equivalent to the average of the last five years' net profit before appropriations excluding the exchange rate and gold value effects.

The General Council of the Riksbank has followed these guidelines since then, with two exceptions. For the financial years 2000 and 2001, the General Council proposed dividend payments of SEK 20 billion over and above these guidelines. The additional dividend payments aroused criticism from both the ECB and the European Commission – the Riksbank's financial independence was not safeguarded in law. Partly as a result of the criticism expressed then, the Government has on several occasions decided to investigate the issue. Given this, the proposal provides greater clarity.

The Riksbank's need of equity reflects the risks on the balance sheet now and in the future. The risks are in turn created by the Riksbank's assets and liabilities and their composition. This composition is a direct effect of the Riksbank's monetary policy, foreign exchange policy and other tasks as well as financial price fluctuations. Changes in the balance sheet are one of the most important tools the Riksbank has to carry out its statutory task. New systems regarding the monetary policy conducted and the Riksbank's liquidity support measures in times of financial unease have been clearly reflected in the bank's balance sheet. Developments in recent decades are a good illustration of this and underline the need for flexibility on this point.

At the beginning of the 1990s, the Riksbank borrowed foreign currency in substantial amounts, around SEK 160 billion, to defend the fixed exchange rate at that time. The Riksbank then had a considerable portfolio of Swedish government bonds (around SEK 145 billion) intended for use in monetary policy operations. This portfolio was finally phased out in 2001 by being transferred to the Swedish National Debt Office as an extra dividend payment to the Treasury. During the financial crisis 2008-2009, the Riksbank lent large amounts to the banking system, almost SEK 370 billion in Swedish kronor and around SEK 250 billion in lending in US dollars.

Shortly afterwards, the currency reserve was strengthened through borrowing from the Swedish National Debt Office. Since the year 2015 the Riksbank has for monetary policy purposes once again acquired government bonds, a holding that currently amounts to around SEK 320 billion and the purpose of which is to support developments in the economy and safeguard the upturn in inflation.

The type of measure now being mentioned strengthens and protects the economy and is necessary for the Riksbank to manage its tasks, but it entails risk exposures and should, all else being equal, increase the Riksbank's need for equity. The equity should cover the changes in value of the net assets caused by fluctuations in both Swedish and foreign interest rates and exchange rates. It should also cover credit losses in connection with liquidity support. As the Riksbank's balance sheet and the risks on it vary over time, a particular level of equity will not always be an appropriate buffer in every situation. The Riksbank's repo-rate forecasts indicate future losses mainly on the bond portfolio, which will lead to the bank's equity declining. However, the Riksbank assesses, as it did in the Annual Report for 2016, that the bank's financial position is still satisfactory. There is thus no reason at present to strengthen the Riksbank's equity.

The Riksbank supports the proposed dividend payment threshold of SEK 60 billion (the targeted equity). But the risks on the Riksbank's balance sheet and thereby the Riksbank's capital requirements can change very rapidly over time. The support therefore assumes that the Riksbank retains its statutory right to make allocations for financial risks and to be able to make a request to the Riksdag for a capital injection regardless of the level of the Riksbank's equity at the time of the request, in accordance with the current regulations in the Sveriges Riksbank Act. A different arrangement would be incompatible with the EU legal principle on the financial independence of central banks.

1.1 Profit allocation rules (Section 5.3)

The Riksbank supports the draft's model for profit allocation.

Given that the Executive Board of the Riksbank has the possibility to make financial allocations according to the ECB's guideline on financial reporting, the Board supports the main features of the draft's proposal that dividends should be paid in the amount exceeding the targeted capital.

The Riksbank has in earlier consultation responses pointed out that all of the dividend payments made by the Riksbank assume that the bank has the possibility to make the financial provisions required to carry out its tasks (see also the ECB consultation response CON/2013/53 point 3.5 and the ECB's Convergence Report 2016 p. 28). The proposal in the draft to establish a reserve fund would mean that allocations can be made to secure the *real value* of the Riksbank's equity. However, the proposal for a reserve fund is not in itself sufficient to satisfy the EU legislation requirement for financial provisions, as the proposal is restricted to securing the *real value* of the Riksbank's equity. According to the proposal, the reserve fund shall *only* contain the value of positive changes in the CPI. The Riksbank must in addition have the right to make provisions corresponding to the feared *decline in value* of the Riksbank's assets, for instance, interest-rate risks and credit risks. There is no comment in the draft as to whether the Riksbank would have the right to make such provisions. However, the Riksbank notes that the possibility to make such provisions is now included in the European Central Bank's guidelines on the legal framework of accounting and financial reporting in the European

System of Central Banks (the ECB's reporting guideline) which became binding for the Riksbank through the national regulation in Chapter 10, Article 3 of the Sveriges Riksbank Act. The ECB's reporting guideline has given the Riksbank the right to make provisions in its balance sheet for certain risks as follows:

"Given the type of operations carried out by the national central banks, a national central bank is allowed to make provisions in its balance sheet for exchange rate risks, interest-rate risks, credit risks and gold price risks. Given a motivated estimation of the national central bank's risk exposure, the national central bank shall decide on how large the provisions shall be and how they shall be used." [1]

These provisions are reported as a liability item on the Riksbank's balance sheet and thereby reduce the Riksbank's reported profit to a corresponding degree. The Riksbank therefore supports the draft's model for profit allocation. The Riksbank wishes to make the following comment in this context:

According to what was stated above, the ECB's regulation on financial provisions is not mentioned in the draft proposal. The Riksbank considers that it should be clarified in the preparatory work for the act that the provisions the Executive Board makes with the support of the ECB's reporting guideline should not be restored to the equity in connection with the Riksdag adopting the Riksbank's balance sheet. The Executive Board has noted that the ongoing parliamentary inquiry on a review of the monetary policy framework and so on (ToR. 2016:114) shall, for instance, consider a system whereby some other instance than the Riksdag shall adopt the Riksbank's balance sheet and profit and loss account. The reason for this review is the European Commission's criticism of the current system where it is the Riksdag and not the Executive Board of the Riksbank that adopts the bank's profit and loss account and balance sheet, something the European Commission considers incompatible with the EU legislation's requirements regarding national central banks' independence. The Riksbank assumes that the necessary legislative changes will be made and that it will thus not be possible for the Riksbank's potential provisions to be restored to the capital by any other decision-making body than the Executive Board.

1.2 Recapitalisation of the Riksbank (Section 5.4)

The Riksbank supports the introduction of a recapitalisation regulation, on condition that it does not curtail the Riksbank's right to make a request to the Riksdag for recapitalisation, regardless of capital level. Although the proposed levels for recapitalisation and guaranteed level are not binding for the Riksdag, it may be useful to clarify that the rule entails an implicit capital guarantee. In addition, central government's responsibility for the Riksbank's capital should be clarified in the legislative text.

The Inquiry into the Riksbank's financial independence and balance sheet, known as the Flam Inquiry (SOU 2013:9), proposed the introduction of a recapitalisation regulation. According to the inquiry, this regulation could remove the need for a special regulation that gives the Executive Board of the Riksbank the right to make financial provisions in its balance sheet (SOU 2013:9 pp. 163 f). The Riksbank opposed the proposal. Through the possibilities to make

[1] Article 8 of Guideline (EU) 2016/2249 of the European Central Bank of 3 November 2016 on the legal framework for accounting and financial reporting in the European System of Central Banks (ECB/2016/34), EUT L 347, 20.12.2016, p. 3.

provisions offered by the ECB’s reporting guidelines (see Section 1.1 above), the Riksbank does not have any objection in principle to a recapitalisation regulation. The Riksbank wishes to point out the following, however:

The member states are not allowed to put their national central banks in a situation where they lack sufficient financial resources and sufficient equity to carry out their tasks within the ESCB or the Eurosystem (see the ECB’s Convergence Report 2016, page 26). Pursuant to Chapter 4, Article 1 of the Sveriges Riksbank Act, the Riksbank already has the right to make a request to the Riksdag to raise the question of an amendment to the statutes or some other measure to be taken by the state. One such measure could, for instance, be the recapitalisation of the Riksbank. The draft's proposal means that this right could be limited with regard to the Riksbank to only apply to situations where the level of the Riksbank’s restricted capital falls below half of the guaranteed level, following the deduction of funds in the revaluation accounts. The Executive Board of the Riksbank assesses that this limitation is incompatible with the fundamental principles of a financially-independent central bank. That the Riksbank should be prevented from drawing to the attention of its principal, the Riksdag, regardless of the current level of its equity, the need for a capital injection, should also be incompatible with the Riksbank’s role as public authority under parliament.

The proposed recapitalisation regulation has another weakness. The proposal must be interpreted to mean that the Riksbank – prior to a request for recapitalisation – is obliged to realise profits entered into the revaluation account via asset sales, with the exception of changes in value in the gold reserve. These sales will affect management of the currency reserve. If the assets that must be sold are held for monetary policy purposes, the sales can be incompatible with the monetary policy conducted – even if they are repurchased shortly afterwards. This part of the proposal therefore contravenes the requirement for an independent central bank.

Given the above, the Riksbank proposes a recapitalisation regulation that clarifies the responsibility of the state according to what the ECB has pointed out in the above-mentioned reference to the ECB’s Convergence Report. It is proposed that the corresponding regulation in the Sveriges Riksbank Act should have the following wording, which is taken from a comment in the preliminary work from 1977 and which is reported in the draft referral to the Council on Legislation:

“The state is responsible for the Riksbank’s capital being sufficiently large to general with a satisfactory margin sufficient return to cover costs and losses that arise in the bank's operations.”

2. The Riksbank's need of currency reserves (Section 6)

The Riksbank opposes the draft's proposal for quantitative limitations to the Riksbank's scope for borrowing foreign currency via the Swedish National Debt Office. Even if the Riksbank is able to fund the currency reserve in its own name, the Riksbank considers the most cost-efficient solution to be for the Swedish National Debt Office to continue to borrow on behalf of the Riksbank. The Riksbank does not consider that it should have the right to unlimitedly and unilaterally decide on borrowing from the Swedish National Debt Office. The Riksbank proposes that the current arrangements, which entail a government debt policy trade-off prior to a decision on borrowing to the Riksbank being granted, are clarified in the legislative text.

The Riksbank opposes the proposal for a reduction of the currency reserve by means of repayment to the Swedish National Debt Office. If this part of the draft's proposal were nevertheless to become law, the Riksbank wishes to point out that the proposal for repayment on 1 January 2018 risks both being expensive and creating market disturbances as a result of the Riksbank having to redistribute the remaining currency reserve. The Riksbank recommends instead that the proposed loan repayment takes place as the loans mature on the Riksbank's balance sheet.

Furthermore, the Riksbank is of the opinion that banks that create large liquidity risks in foreign currency shall also foot the bill for the part of the currency reserve that the

2.1 Banks' dependence on foreign currency – risk to financial stability

Sweden has a large and expanding cross-border banking sector with significant commitments in foreign currency. The Swedish banking system's total balance sheet amounted to SEK 17,250 billion in January 2017[2], which is four times Sweden's GDP. Funding in foreign currency in the four major banking groups amounted to 175 per cent of GDP, i.e. SEK 7,650 billion[3].

This size and structure of the financial system can pose significant risks to financial stability and ultimately the national economy. The risks are not only to the Swedish economy but also the economies of Sweden's neighbouring countries, where Swedish banks have operations. It is therefore a matter of urgency that the banks' insure themselves in the form of adequate liquidity reserves, but it is also important that the Riksbank has an adequate currency reserve in order to be able to fulfil its function as lender of last resort in both Swedish kronor and foreign currency. The existence of this type of robust insurance is necessary in order to uphold confidence in the Swedish financial system internationally, confidence that is absolutely central, given the financial system's high degree of overseas dependence.

2.2 Borrowing in a crisis is high-risk – pre-financing important

With the current arrangements, the currency reserve can be funded either by holding currency in advance or by borrowing or purchasing currency once a crisis has already broken out. Pre-financing the currency reserve obviously involves running costs that are avoided in a "crisis-funding" arrangement. But thanks to the pre-financing, liquidity is very high. The currency reserve's assets can be made available for liquidity support to the banking system at short

[2] Statistics Sweden's Financial Market Statistics 2017.

[3] 31 December 2016

notice. On the other hand, waiting until a crisis occurs before funding the currency reserve is problematic in several ways.

One problem is having to obtain very large amounts in a short time-frame. When the Riksbank offered liquidity support in US dollars during the autumn of 2008, the need was very great. In four weeks, the Riksbank lent US dollars equal to about SEK 200 billion. Good crisis preparedness presupposes that even larger amounts can be generated in an even shorter time-frame.

Even with well-functioning financial markets, extensive borrowing can take time in order to avoid influencing interest rates too much. During the 1990s crisis, borrowing the first SEK 100 billion was achieved relatively quickly but it then took more than six months to borrow a further SEK 60 billion.[4] During the most recent financial crisis, it was deemed possible to borrow SEK 100 billion in a couple of weeks without impairing Sweden's borrowing options and making them more expensive. It was also estimated that a further SEK 100 billion could not be borrowed until three months later.[5]

Substantial and rapid borrowing once a crisis has broken out therefore risks inflating central government's borrowing costs, and in a worst-case scenario, it might be difficult to borrow the required amount in time. Another problem is that substantial and rapid borrowing risks sending the wrong signals. If central government borrows large amounts in a short time-frame, it can be interpreted as the Riksbank or other authorities regarding the situation in the economy more seriously than was previously evident, which could undermine confidence in the Swedish economy and hence further exacerbate the economic situation.

Furthermore, banks may need liquidity support in foreign currency at the same time as the central government has less scope for borrowing on the capital markets and these two problems thereby risk reinforcing each other. Bank crises have often coincided with sovereign debt crises[6] and the combination has often proved particularly costly for the real economy[7]. A bank crisis can also undermine the state's credit rating as it is expected to absorb losses or because the banking crisis is expected to lead to much worse growth in the real economy. The larger the banking system is in relation to the size of the state, the greater is its influence.

As rapid or unexpected borrowing leads to higher interest rates, the Riksbank's scope for creating impact for its monetary policy will also be reduced. A well-considered currency reserve creates confidence in the economy and counters harmful speculation against Swedish financial markets.

A comparison with Ireland can be illustrative. Within the course of a few years, Ireland lost its AAA+/Aaa[8] rating and was downgraded to BBB+/Ba1. At the same time, the country's borrowing requirement increased rapidly as its financial crisis evolved into a sovereign debt crisis. Two-year government bond yields rose from 2.5 to 22.5 per cent, ten-year yields from 5 to 13 per cent. Interest expenditure for central government borrowing increased in the

[4] The Riksbank 1993 Annual Report and official notes.
[5] The Riksbank official notes.
[6] Reinhart and Rogoff, 2011.
[7] De Paoli et al, 2009.
[8] Credit ratings from Fitch Ratings and Moody's Investors Service.

government budget from about 3 to over 10 per cent of GDP, which forced substantial cutbacks in other expenditure areas.

Another illustrative example of how quickly major changes can occur in a crisis is the developments on Iceland in connection with the latest financial crisis. Iceland lost its credit-rating very rapidly from A+[9] in September 2008 to BBB- in October the same year. One euro cost 90 Icelandic kronor at the beginning of 2008 but by October the same year, the exchange rate had depreciated to ISK 340 per euro before trading in ISK was suspended completely. Simultaneously, the Icelandic policy rate rose to 18 per cent despite a floating currency. A government budget with a 5 per cent surplus in 2007 was transformed into a deficit of 13 per cent in 2008. In addition, the risk premiums for Iceland on financial markets were high for a long time after the crisis which shows how difficult it is to re-establish confidence once it has been lost.

Swedish experiences also demonstrate that it takes a long time to regain confidence. The domestically generated crisis suffered by Sweden about 25 years ago culminated in the country having to abandon the fixed exchange rate in 1992. However, the crisis also led to a number of key reforms being implemented: monetary policy received an inflation target, an entirely new framework was introduced for public finances, and both the pensions system and social insurance system underwent fundamental reform. Despite this, the yield gap in relation to Germany persisted with a very large risk premium for a number of years (the premium fluctuated sharply, by 1 to 5 percentage points between 1993 and 1997).

2.3 Other funding options in a crisis – significant limitations

The Riksbank has the option of buying foreign currency in a crisis situation and paying with Swedish kronor, but this would also be expensive, take time and risk impacting the exchange rate. This could in turn have undesirable macroeconomic consequences and come into conflict with monetary policy.

One alternative is to try to obtain foreign currency by establishing swap agreements with other central banks. Generally speaking, it is more difficult for a smaller economy to conclude such an agreement than it is for a larger one, and Sweden is not a significant financial centre on a global level. The preconditions for establishing swap agreements are also affected by the nature of the crisis. If it is a question of a global financial crisis, it is probably easier to establish swap agreements, than if it is a question of, for example, a property crisis limited to one's own country, such as the Swedish crisis of the 1990s. It is also important to note that swap lines can be cancelled as soon as it is no longer in the counterparty's interest to support liquidity in the currency affected.

During the latest global financial crisis, the Riksbank concluded some swap agreements with central banks in other countries. However, the Riksbank's experiences after the end of the crisis are that it has been difficult to conclude such swap agreements.[10] If the Riksbank's own buffer, the currency reserve, were to be halved, it is expected to become even more difficult to put in place this type of agreement. Financial stability is an issue where there is a mutual dependence among countries and a clear common responsibility and interest. Every country is

[9] Credit rating from Fitch Ratings.

[10] The Riksbank, official note.

therefore expected to do its best to contribute. If other countries were to think that Sweden was not prepared to pay the cost for insuring itself in a reasonable way, they would be less likely to come to its aid in a crisis. Furthermore, certain central economies are developing towards more introverted economic policy, which probably further impairs the prospects for this type of agreement.

Another option is for central government to issue guarantees for banks' foreign funding. The value that the international capital market attaches to public sector guarantees during a crisis, especially for an economy with a banking system that is several times larger than its GDP, is an open question and good crisis preparedness should not rely on a throw of the dice.

Another option is to borrow from the IMF in a crisis situation. Such loans obviously require approval from the IMF, which risks slowing down crisis management, and implies requirements in return, which restricts Sweden's freedom to act. More generally, putting oneself in a situation that makes it more likely that one has to apply to the IMF for support hardly seems an appealing scenario.

In summary, the Riksbank takes the view that a pre-financed currency reserve is an important precondition for the Riksbank's ability to satisfactorily fulfil its role as lender of last resort and to sustain the effectiveness of its monetary policy. First of all, the alternative of funding the currency reserve in the event of a crisis (via the Swedish National Debt Office or in its own name) may make it difficult to borrow the large amounts needed quickly enough once the crisis has broken out. Secondly, it may well be considerably more expensive to borrow in a crisis compared with borrowing under normal circumstances. Thirdly, the probability of being affected by a crisis increases as resilience and international confidence is lower.

2.4 The currency reserve should not be lower than its current level

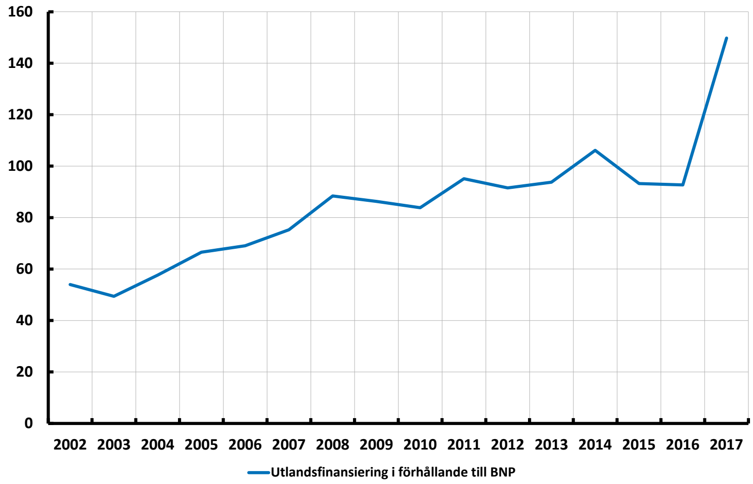
An analysis is needed of the risks that the currency reserve is intended to cope with in order to assess how large it should be. These risks are highlighted in the figure below. The proposed change to the currency reserve, i.e. a reduction by SEK 257 billion, basically means it would be halved in size. At the same time, the Swedish banking system's foreign funding has grown substantially during the 2000s.

The proposed reduction of the currency reserve is to be seen in the light of the banks' foreign funding as a share of GDP having tripled since the beginning of the 2000s up until the present day, and currently amounts to 150 per cent of GDP, see Figure 1. The substantial increase in the banking system's foreign funding at the turn of the year 2016/2017 is mainly due to Nordea's transformation into a branch structure, when the legal residence of some funding in foreign currency was moved to Sweden. At the same time, it should be pointed out that additional funding in foreign currency remains in the major Swedish banks' foreign subsidiaries, including in Nordea's mortgage lending companies in Denmark, Norway and Finland If this funding were also to be included, foreign funding would amount to 175 per cent of GDP.

So, while the banks expand strongly abroad and increase their overseas dependence, the Riksbank's currency reserve – with the proposed change – would be substantially reduced in size. The currency reserve's share of the banking system's foreign funding in 2016 was back to the same level as in 2002, but would, as a result of the intervention proposed in the draft, fall dramatically, see Figure 2.

Figure 1: Swedish banking system's foreign funding in relation to GDP

Per cent

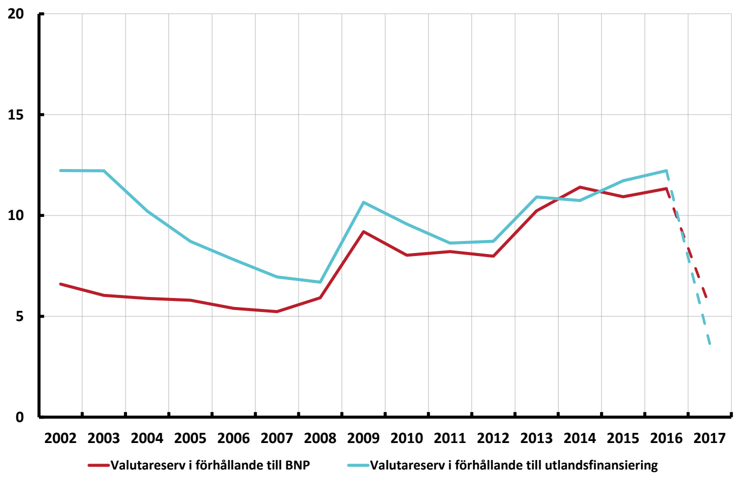


Note: Foreign funding refers to Swedish banks' (including Swedish subsidiaries but excluding foreign subsidiaries) market funding and deposits in foreign currency. The increase is due to Nordea's previous foreign banking subsidiaries being incorporated into the Swedish parent company since the turn of the year.

Source: Statistics Sweden

Figure 2: The Riksbank's currency reserve in relation to GDP and to the Swedish banking system's foreign funding

Per cent



Note: Foreign funding refers to Swedish banks' (including Swedish subsidiaries but excluding foreign subsidiaries) market funding and deposits in foreign currency. The broken part of the line represents the Riksbank's forecast based on the reduction of the currency reserve proposed in the draft.

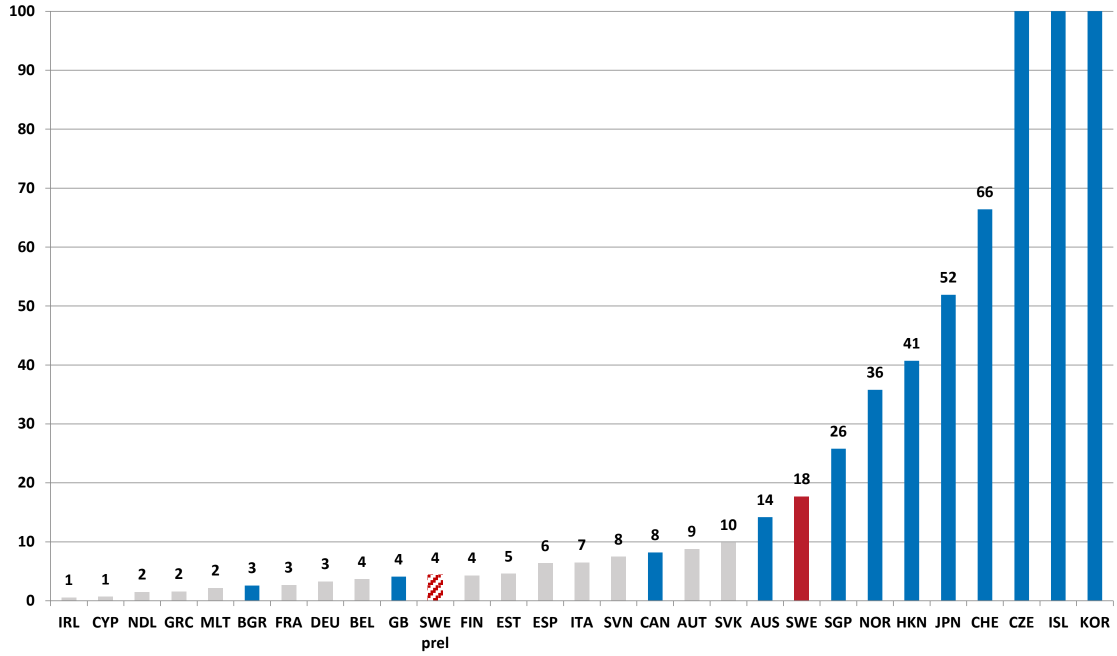
Sources: Statistics Sweden and the Riksbank

So what have other countries done? The IMF has compared other countries' currency reserves as a share of the country's short-term liabilities in foreign currency, see Figure 3. Using this measure, the Swedish currency reserve – if reduced to the extent proposed in the draft –

would provisionally cover just 4 per cent of the banking system's short-term currency liabilities, as the effects of Nordea's transformation into a branch structure at the turn of the year 2016/17 are included in the calculation. The corresponding figure before these two changes was 18 per cent. The countries with lower currency reserves are the euro countries (with the exception of Bulgaria) which, similar to the United States, enjoy the benefit of holding a contingency fund. Furthermore, as euro members they have a greater change of receiving liquidity in euros from the ECB.

Figure 3: The currency reserve as a share of the country's short-term liabilities in foreign currency in 2016

Per cent



Note: Grey-coloured countries belong to the euro area.

Sources: The IMF and the Riksbank.

The Riksbank has published calculations showing that a suitable size of the Riksbank's currency reserve is at least at its current level. A summary of these calculations is presented in the Appendix to this consultation response. The IMF has made similar calculations and come to the conclusion that the currency reserve should not be less than it is today.[11] In its latest global stability report[12], the IMF also points out a growing concern about the fact that non-US banks are increasing their dependence on funding in US dollars. In the report, the IMF calls on countries with limited currency reserves and a lack of swap lines, like Sweden, to consider measures aimed at strengthening their protection.

It should furthermore be noted that the Swedish banking system is also systemically important in the Nordics and Baltic States, a fact pointed out by the IMF in its analysis of the financial

[11] IMF Article IV 2016.
[12] Global Financial Stability Report, April 2017.

sector in Sweden[13]. The major Swedish banks are identified by, for example, the Baltic and Nordic central banks as a threat to financial stability in their countries.[14] The fact that the Riksbank is well capable of supplying liquidity support in foreign currency and reducing the risks in the financial sector is therefore of considerable importance to the entire Nordic-Baltic region.

Given the draft's proposal on the future size of the currency reserve, it can be concluded that the Government considers the Riksbank's and the IMF's calculations to be overestimated. However, the draft contains no analysis or argumentation showing why a currency reserve of only SEK 200 billion would be more economically appropriate that then level recommended by the Riksbank and the IMF.

Finally, as regards the issue of how the size of the currency reserve may need to vary over time, it can be ascertained that the need for a currency reserve is nowadays mainly connected to the size of the banking system and its foreign funding. The size of the currency reserve should reasonably be determined by how these variables develop.

In summary, the Riksbank's assessment is that the currency reserve should not fall below its current level.

2.5 Build-up of the currency reserve via the Swedish National Debt Office

How can the build-up of the currency reserve be accomplished? There are various alternatives. Under the current regulations, the Riksbank has the possibility of asking the Swedish National Debt Office to borrow currency to strengthen the Riksbank's currency reserve. In recent years, the Swedish National Debt Office has twice (2009 and 2012) carried out such borrowing at the Riksbank's request. From an economic perspective, this arrangement is cost-efficient, as the Swedish National Debt Office has expert knowledge and there are efficiency gains to be made from gathering all government borrowing in one authority.

The current regulations do not specify any restrictions on how large the Riksbank's borrowing of foreign currency via the Swedish National Debt Office may be. However, the Executive Board of the Riksbank understands that such borrowing may have major government debt and budget policy consequences and may disrupt the budget policy frameworks. This is because borrowing by the Swedish National Debt Office influences national debt and the so-called Maastricht debt (see SOU 2016:67), which is not the case when the Riksbank borrows under its own name[15]. Legislation must balance the various interests connected with currency borrowing to strengthen the Riksbank's currency reserve.

The draft referral to the Council on Legislation proposes that the Riksbank's right to borrow foreign exchange via the Swedish National Debt Office be restricted. The Riksbank has no objection in principle to there being restrictions. The Riksbank always has the possibility of funding the currency reserve in its own name (see Chapter 6, Article 5 and Chapter 7, Article 4 of the Sveriges Riksbank Act). In addition, this right must be considered an expression of the

[13] IMF Financial System Stability Assessment, November 2016
[14] Eesti Pank Financial Stability Review 2/2016, Latvijas Banka Financial Stability Report 2016, Lietuvos Banka Financial Stability Review 2016, Bank of Finland Bulletin 2/2016
[15] If the Riksbank borrows foreign currency in its own name, this does not affect the non-consolidated national debt, as this transaction does not demand that the Swedish National Debt Office supplies any debt instruments. As the Riksbank is classified as part of the financial sector in the statistics, neither does such a transaction affect the consolidated national debt according to the National Accounts, the Maastricht debt or central government financial net wealth.

Riksbank's financial independence. Nevertheless, the Riksbank opposes the quantitative restrictions implied by the proposal. Even if the Riksbank is able to fund the currency reserve in its own name, it seems most cost-efficient for the Swedish National Debt Office to continue to conduct such borrowing on behalf of the Riksbank. However, the Riksbank should not have the right to unlimitedly and unilaterally decide on borrowing from the Swedish National Debt Office. The current arrangements, which mean that the Swedish National Debt Office must, within its mandate, make a government debt policy trade-off must be made prior to a decision on whether borrowing to the Riksbank is to be granted, should be clarified in the legislative text.

2.6 Build-up of the currency reserve via funding in the Riksbank's own name

The Riksbank's currency reserve was strengthened in 2009 and 2012. Operational circumstances, efficiency reasons and the urgent nature of the matter at hand meant that the borrowing was implemented by the Swedish National Debt Office, even though the Sveriges Riksbank Act provided scope for the Riksbank to issue its own promissory notes in foreign currency. The Riksbank notes that the draft proposal for restrictions to the Riksbank's right to borrow foreign exchange via the Swedish National Debt Office has considered the Riksbank's other possibilities for obtaining foreign currency (draft page 30). The Riksbank will thus retain the possibility of strengthening the currency reserve via monetary and foreign exchange policy borrowing in its own name pursuant to Chapters 6 and 7 of the Sveriges Riksbank Act, something which is necessary for the bank to be considered financially independent under EU law.

Another possibility for the Riksbank to strengthen the currency reserve is by purchasing foreign currency with Swedish kronor, if this is justifiable from a monetary or foreign exchange policy perspective. Indirectly, such a situation may arise if the Riksbank deems that the currency reserve is too small for the Riksbank to be able to fulfil its task of promoting financial stability and safeguarding the impact of its monetary policy. Furthermore, this would have to take place over a longer period to avoid major effects on the exchange rate. Funding the currency reserve by this method has the advantage of creating an even clearer separation between the Riksbank's currency reserve and public finances.

To the extent that the Riksbank chooses to fund the currency reserve in foreign currency, the Riksbank considers further borrowing via the Swedish National Debt Office to be the most cost-efficient funding option. However, the Riksbank also understands that such borrowing may disrupt budget policy processes and frameworks and can – if the Swedish National Debt Office does not consider borrowing to be appropriate – instead utilise the option of funding the currency reserve in its own name.

2.7 The financial sector should bear the costs of the currency reserve

The currency reserve should be seen as an insurance policy that not only reduces the risk of crises, but also ensures good protection when they nevertheless occur. The cost of this protection – the insurance premium – has been calculated by the Government at SEK 500 million per year for the borrowed part of the reserve. This is an estimate for a particular year, but an assessment of the cost should be made over a longer period, as the costs (and the - revenues) have varied considerably over time. The funding cost of the borrowed part of the currency reserve is reduced by funds being invested in interest-bearing assets. The way that funds are invested and the development of the market affect the net result of the pre-financed currency reserve.

In recent years, the Riksbank’s monetary policy measures and liquidity measures have generated a surplus. The revenues from these operations have far exceeded the costs of funding the borrowed part of the currency reserve. The aim of the Riksbank’s measures has assuredly not been to earn money, but this has been the consequence. As the repo rate has been negative since February 2015, the Riksbank received incomes on the monetary policy debt of about SEK 434 million in 2015 and SEK 1.6 billion in 2016. During the financial crisis, when the repo rate was positive, lending in Swedish kronor amounted to SEK 265 billion in 2008 and SEK 369 billion in 2009. Over 2010, the Riksbank’s extraordinary lending was phased out and, by the end of 2010, one loan of SEK 500 million was left. The Riksbank’s extraordinary lending took place at the repo rate plus a small premium (of between 0.25 and 0.5 percentage points). This generated net income totalling SEK 2.56 billion. On the other hand, it is likely that the Riksbank will make losses on the Swedish government bonds that the Riksbank has purchased for monetary policy purposes since February 2015. The losses will arise to the extent that the level of interest rates becomes normalised faster than was expected by the markets on the dates of purchase.

One important aspect to be considered in this context is how the cost of maintaining the currency reserve should be allocated. To create healthy incentives, it is important that the insurance is paid for by those benefiting from it. Above all, a confidence-inspiring currency reserve benefits the financial sector, primarily the major Swedish banking groups. The liquidity in foreign currency that constitutes the Riksbank’s currency reserve, combined with Sweden's good public finance situation, probably means that the risk premium when the banks are obtaining funding on the international capital markets is lower than it would otherwise have been. So far, however, the cost of the currency reserve has only been charged to the Riksbank and government finances.

The directives for the Inquiry into the Riksbank’s financial independence and balance sheet (SOU 2103:9) included investigating whether there was reason to introduce an insurance-based system of fees for managing the costs of the currency reserve, something which did not happen. The Riksbank has also taken up the matter of the funding of the currency reserve on a number of occasions. Furthermore, the Riksbank is of the opinion that banks that create large liquidity risks in foreign currency shall also foot the bill for the part of the currency reserve that the Riksbank holds in order to be able to supply them with liquidity support. However, the draft does not comment on the Riksbank’s proposal.

Various ways of transferring this cost to the banks can be imagined. Their common characteristic is that they aim both to cover the cost of maintaining a currency reserve and to give the banks an incentive to reduce their liquidity risks in foreign currency.

Once conceivable model is based on a fees system, where the fee paid by a bank is proportionate to the liquidity risks in foreign currency taken by that bank – the greater the risk, the higher the fee. Another model is that the Riksbank is granted the legal conditions to introduce a reserve requirement in foreign currency aimed at promoting a safe and efficient payment system. Reserve requirements in Swedish kronor could also be used for this purpose to a certain extent. Such a requirement would mean that a part of the banks’ borrowing in foreign currency would have to be deposited in the Riksbank, where it would be available for use by the bank in the event of a financial crisis.

In summary, the Riksbank proposes therefore that the scope for transferring the costs for parts of the currency reserve to the banking sector be investigated. Such a change has benefits both when it comes to creating healthy incentives for the banks and from a government finances perspective.

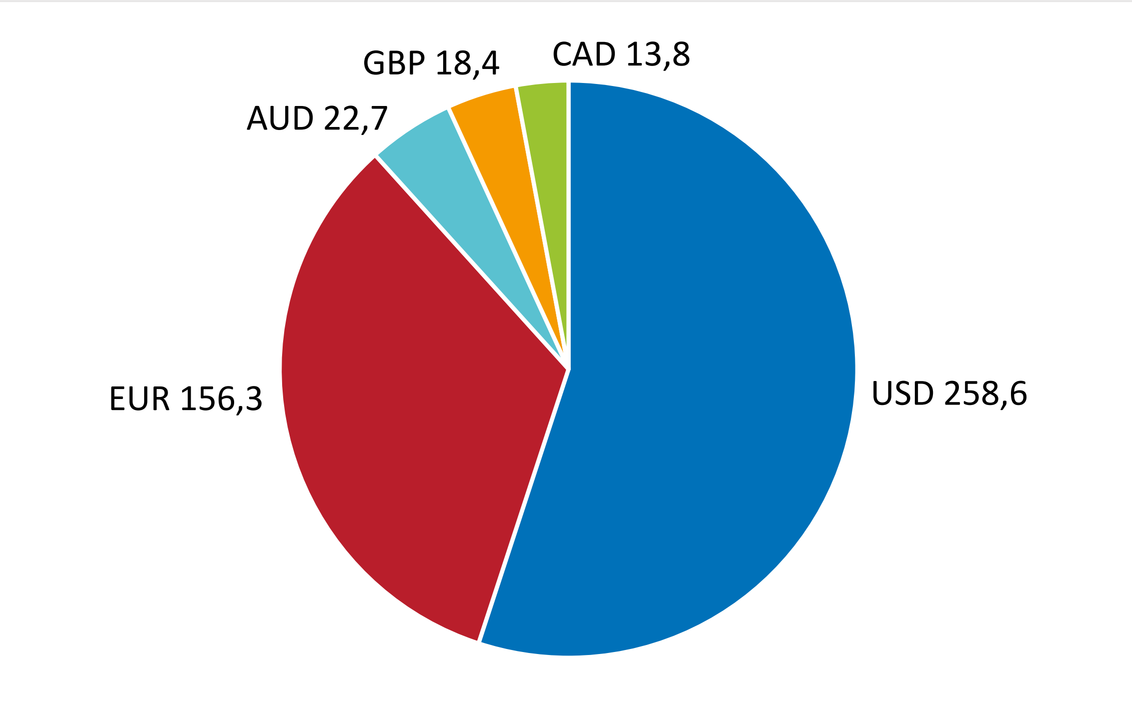
2.8 Requirement for repayment of borrowed currency reserve funds – legal and practical aspects

According to the draft, the currency reserve funds borrowed by the Swedish National Debt Office on behalf of the Riksbank are to be repaid on 1 January 2018.

The ECB's statement CON/2013/53 point 3.5 makes it clear that Member States must not prescribe reductions in a national central bank's capital without the prior consent from the national central bank's decision-making body. The aim is to ensure that the national central bank as a member of ECBS is sufficiently financially independent in order to be able to fulfil its task pursuant to Article 127.2 in the Treaty and the ESCB constitution. As the proposal means that the Riksbank, in contravention of the agreement it currently has with the Swedish National Debt Office, is to repay the funds it has borrowed from the National Debt Office – with the exception of SEK 50 billion if the Riksbank deems there to be exceptional grounds – this represents a breach of the principles for an independent central bank.

Figure 4: Currency reserve assets as of 31 December 2016

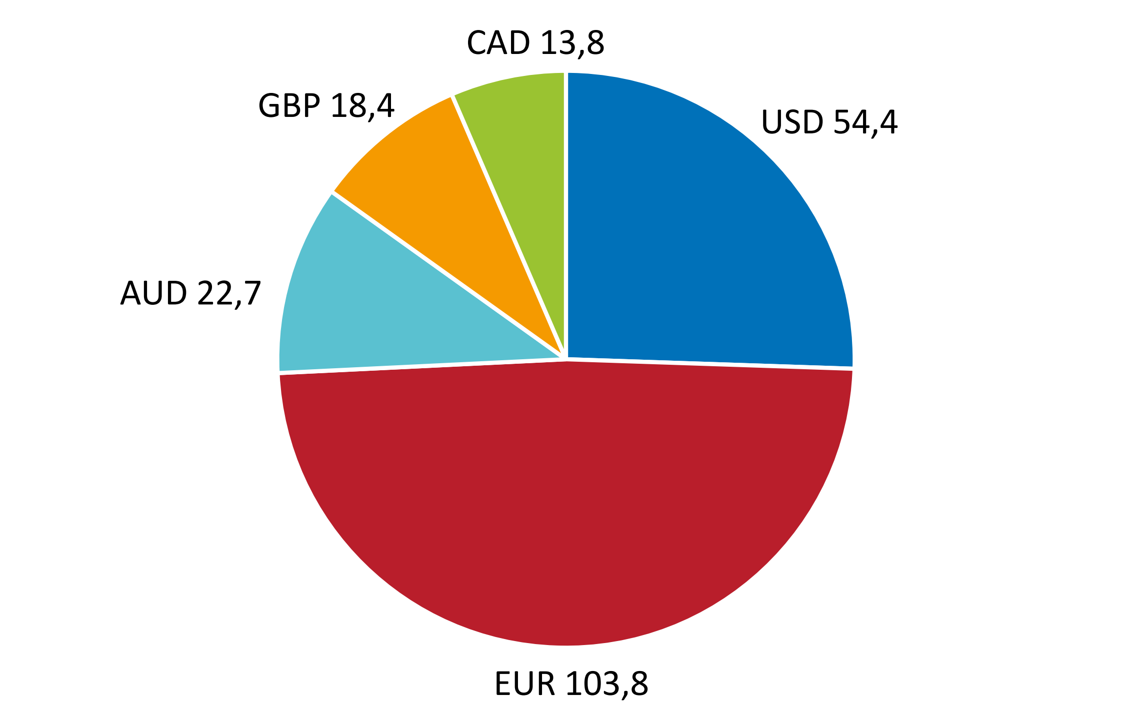
SEK billion



Source: The Riksbank's Annual Report 2016

Figure 5, Currency reserve assets in the event of an immediate loan repayment

SEK billion



Note: The figure shows currency reserve assets as of 31 December 2016 minus the currency loans from the Swedish National Debt Office as of the same date.

Source: The Riksbank's Annual Report 2016

In case the legislator were to make a different legal assessment in this issue, the Riksbank would also like to point out that the proposals also involves practical difficulties. The current composition of the currency reserve reflects the trade-offs that the Riksbank has made in order for it to be able to fulfil its liquidity supply commitment at short notice, see Figure 4. If the draft's proposal is realised and comes into effect on 1 January 2018, the currency reserve will have the composition outlined in Figure 5. For the Riksbank to have an appropriate composition of the currency reserve, the Riksbank would need to perform extensive transactions aimed at restoring the original composition. Such a rapid transformation is costly and risks creating market disturbances.

The Riksbank therefore recommends that the proposed repayment of the loans, if implemented, shall take place gradually. Suitably, this can take place as and when the loans mature in accordance with Riksbank and Swedish National Debt Office agreements. The Riksbank can then gradually replace the loans that mature with funding under its own name in either Swedish kronor or foreign currency. In this way, it is possible to ensure that the currency reserve has an appropriate composition during the transitional period and reduce the risk of excessively large costs.

On behalf of the Executive Board:

Stefan Ingves

Kerstin Haglund

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

Reports were presented by Pernilla Meyersson and Eric Frieberg.

Appendix

Calculating an appropriate size for the Riksbank's currency reserve

The Riksbank regularly assesses the Swedish banking system's need of liquidity support in foreign currency in a crisis situation. In the Riksbank's base scenario for a feasible crisis, this requirement amounts to SEK 535 billion over three months. A sensitivity analysis shows that this amount could either decrease or increase, depending on how certain assumptions change. The IMF's assessment of the requirement over three months, based on the same basic data and similar methodology, is that the currency reserve should not fall below 11 per cent of GDP, which corresponds to SEK 484 billion.[16]

The Swedish banks are large and conduct comprehensive operations outside Sweden. The Swedish banking system's total balance sheet amounted to SEK 17,250 billion in January 2017, which is four times Sweden's GDP. Funding in foreign currency in the four major banking groups amounted to 175 per cent of GDP at the same point in time, i.e. SEK 7,250 billion.

In neighbouring countries in the Nordic and Baltic region, several of the Swedish banks are of such size as to be vital for financial stability. They have large loan portfolios as well as deposits and wholesale funding in currencies other than Swedish kronor. Furthermore, borrowing takes place in US dollars, euros and other currencies on the international markets. These are then exchanged to also fund lending in both Swedish kronor and other Nordic currencies.

By borrowing in other currencies, the banks fund assets with significantly longer maturities, such as mortgages, but also commercial investments in the industrial sector. The banks are thus exposed to the risk that their international financiers will be unwilling to renew the loans they have taken, at the same time as assets in foreign currency will remain on the balance sheet, which may lead to liquidity problems and the risk of default. In addition to acute liquidity problems, the banks may be forced to reduce their credits in foreign currency, i.e. a credit crunch will occur, in which lending will be constricted and those customers who can will be forced to repay their loans, possibly having very serious consequences for the economy.

Scenario analysis

The Riksbank regularly assesses the Swedish banking system's need of liquidity support in foreign currency in a crisis situation. An important basis for these assessments is scenario analyses based on data reported by banks to Sweden's financial supervisory authority, Finansinspektionen. In the scenario analysis, these data are combined, among other things, with assumptions about (i) the maturity structure of banks' lending, (ii) the maturity structure of banks' funding, (iii) how much of banks' own liquidity reserves are available to counter currency outflows, and (iv) how long the crisis will last.

[16] The amount of SEK 484 billion is based in Sweden's GDP for 2016.

Assumptions in the base scenario

The Riksbank has defined a base scenario for a feasible crisis based on both the LCR (Liquidity Coverage Ratio)[17] and historical experiences of the in- and outflows of foreign currency and the use of liquid assets under stress.

The assumptions made in the base scenario include:

- A fall in banks' deposits in foreign currency from households of 5 per cent and from companies of 25 per cent.
- The banks' lending remains unchanged, i.e. no credit crunch for borrowers.
- No access to securities funding markets for Swedish banks.
- Only central bank money and government securities can be used to generate liquidity on capital markets. Covered bonds, corporate securities and other assets are assumed to be illiquid on private markets.
- Banks choose not to allow their LCRs to fall below 75 per cent. This means that banks do not dispose of or pledge all their most highly liquid assets in foreign currency to counter the currency outflows.[18]
- The scenario runs for three months.
- Holdings of US dollars and euro can be interconverted or converted to less liquid currencies such as DKK, NOK and GBP.
- Assets in domestic currency that are funded in foreign currency in the form of currency swaps can, if necessary, be replaced by funding in domestic currency.

The requirement amounts to SEK 535 billion

With these assumptions, the banking system's need for refinancing from the Riksbank's currency reserve over a three-month period can be estimated to the equivalent of SEK 535 billion.

The above analyses consider neither the monetary policy arguments in favour of maintaining a currency reserve nor the assumptions made by the Riksbank in relation to the IMF and other international organisations or central banks.

[17] The LCR is part of the Basel III banking regulations, adopted by the Basel Committee in the wake of the global financial crisis. The purpose of the LCR is to improve banks' resilience to liquidity risks. The LCR requires banks to have a buffer of liquid funds to cope with unexpectedly large cash outflows in accordance with a certain predefined stressed scenario that lasts for 30 days.

[18] There may be several reasons why banks are not entirely able or do not wish to exhaust their own reserves before seeking support from the Riksbank; perhaps collateral is required to complete intraday payments, or perhaps excessively low liquidity reserves may undermine confidence in the bank's ability to recover.

Sensitivity analysis – summary

The uncertainty in these calculations is considerable and the calculations are also sensitive to the assumptions made. With different assumptions, the currency need may be considerably larger or smaller. A brief sensitivity analysis is presented below.

Table 1 and the accompanying sensitivity analysis illustrate how the amounts are affected when the assumptions change. As the banks' liabilities in foreign currency are so large, even small changes in the underlying assumptions can have a major effect on the currency requirement, both in absolute terms and in relation to the size of the currency reserve.

Table 1. Liquidity requirement during three months of stress
SEK billion

Minimum level of banks' LCRs	More liquid assets	10% credit tightening	Base scenario	Larger outflows: -15% household deposits	Larger outflows: -40% company deposits
75%	362	478	535	691	845
50%	189	219	263	354	489

Note: In the base scenario, banks' choose not to allow their LCRs to fall below 75 per cent. If banks allow their LCRs to fall below 50 per cent, the liquidity requirement decreases.
Source: The Riksbank

Sensitivity analysis

More liquid assets (liquidity requirement: SEK 362 billion)

The base scenario assumes that only central bank money and government securities can be used to generate liquidity, so-called Level 1 High-Quality Liquid Assets (HQLA). But if the banks' other liquid assets (e.g. covered bonds) are also included, i.e. Level 2 HQLA, their liquidity requirement falls to SEK 362 billion.

10 per cent credit tightening (liquidity requirement: SEK 478 billion)

The base scenario assumes that the balance sheets will be retained, i.e. all new lending to the general public will be stopped and all existing lending will be rolled over. But if only 90 per cent (instead of 100 per cent) of the loans that mature within three months roll over, banks' liquidity requirements will decrease by around SEK 50 billion, compared to the base scenario.

Larger outflows, household and company deposits (liquidity requirement: SEK 691 billion and SEK 845 billion respectively)

The base scenario assumes that 5 per cent of household deposits and 25 per cent of company deposits are withdrawn. If withdrawals instead amount to 15 and 40 per cent respectively, banks' liquidity requirements will increase by SEK 100–300 billion compared to the base scenario. If this happens, however, economic activity will also be further squeezed in the crisis.

Convertibility between different currencies (liquidity requirement: SEK 740 billion)

In the analysis, it is assumed that full convertibility prevails, i.e. that US dollars and euros can be converted to less liquid currencies such as NOK, DKK and GBP. If convertibility does not prevail, it means that the Riksbank may need to step in and provide liquidity support in these currencies. If this were to be the case, the need for a currency reserve increases, all other factors being equal, from SEK 535 billion to SEK 740 billion (this part of the sensitivity analysis is not included in Table

1). The majority of this increase is due to the exposure to NOK, followed by DKK, while the effect of the exposure to GBP is relatively minor compared with the effect of the two Nordic currencies.

Level of banks' buffers are allowed to fall to 50 per cent of the LCR requirement

If the banks allow their own currency buffers to be reduced to 50 per cent (compared with the LCR requirement of 100 per cent) instead of 75 per cent before they assess that they need central bank support, this will halve the liquidity requirement. If the market finds out that the banks' own holdings of eligible assets in foreign currency has fallen below certain levels, there will be a risk that the market will consider that the bank in question is no longer an acceptable counterparty. In addition to this, the banks will need a certain amount of eligible assets to be able to execute payments and manage intraday liquidity. It is not possible to determine in advance what constitutes a minimum critical limit for the LCR from the banks' perspective before they demand central bank liquidity, but, based on the discussions the Riksbank's staff have had with the IMF, it seems reasonable that the critical limit is above 50 per cent, even if the exact figure is difficult to pinpoint.