SWEDISH NATIONAL AUDIT OFFICE

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Summary:
Protection for pension savers - and pension companies' investments in covered bonds

The Swedish National Audit Office has audited whether the actions of the Government and Finansinspektionen (Swedish Financial Supervisory Authority- FI) have met the Riksdag's objective of a high level of consumer protection during a period when central government was acting to protect financial stability.

Audit background

Financial institutions, such as pension companies and banks, are separately regulated, as well as being subject to the rules that generally apply to companies. The audit covers regulations and supervision that are to protect the special priority right of pension savers and investors in covered bonds so that pension companies and banks can meet their commitments. Pension companies must be able to pay guaranteed pensions and issuing banks must be able to repay bond loans that mature. This requires the existence of assets that correspond to the value of the debt, in other words the claim that pension savers and investors have on pension companies and banks respectively. Fundamental to the protection is that these liabilities and assets are adequately valued. The assets must be kept separate in the pension companies' registers and in the banks' cover pool.

The audit refers to the period 2006-2013 and relates to pension companies that promise guaranteed pensions and banks that issue covered bonds. The economic link between pension companies and banks was also investigated, as pension companies are large investors in such bonds. Consequently, FI's regulation and supervision are significant in both cases for the protection of pension savers.

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There were several reasons to audit whether regulation and supervision have functioned as intended, as both pension companies and issuing banks had problems during the financial crisis. It became more expensive for the banks to borrow via the bond market to finance mortgages and other business operations. When investors moved to more secure assets their demand for government bonds increased. The effects of financial regulation had an impact on demand, which contributed to falling yields on government securities. When it became increasingly difficult for the banks to borrow via the market the liquidity crisis had become a reality. Central government intervened to support the banks and the financial system, leading to a decrease in the banks' costs for issuing covered bonds. At the same time, falling yields became a problem for the pension companies since falling yields increased their liabilities to pension savers and the pension companies redirected investments from equity to bonds. This gave rise to effects that not only affected the pension companies, but also the financial system, leading to an adjustment of the regulations by FI.

Audit findings

Financial regulation is a necessity for the financial market and a premise for FI's supervision. The audit shows that the regulation led to some undesired effects and that FI had to change its regulations for pension companies several times. At the same time, FI was less active in regulating the issuing banks.

The need for supervision increased during the crisis. FI, which supervises more areas than those audited in this report, was forced to prioritise its measures. According to the Swedish NAO, FI should have given priority to a greater extent to in-depth investigations into the protection of pension savers' and investors' priority right, as well as the banks' issuance of covered bonds. It will also be necessary in the future for FI, when the need for supervision increases, to intensify its on-site supervision of the companies. In that case it will not be sufficient to conduct supervision solely via reporting. In-depth supervision includes the behaviour of the banks and pension companies in the market, so that their actions do not lead to a risk level in excess of their financial strength. Otherwise it may have effects on pension savers and investors in covered bonds and the stability of the system.

Financial regulation impacts the bond market

The audit shows that in some situations regulation can have unforeseen effects and augment imbalances between supply and demand in the bond market. There is currently no survey or analysis of the extent to which demand for bonds is affected by financial regulation or the possible effects it may have.

It was reasonable for central government to take all aspects of public interest into consideration when supporting the banks. This led among other things to a functioning market for covered bonds during the crisis. Central government measures also secured pension companies' holdings in bank-related assets. But there is still no survey or evaluation of how financial regulation and central government measures affect pension companies as counterparties when the State and banks issue bonds.

The Swedish bond market is characterised by a limited supply of bonds with maturities of more than ten years. The average maturity for covered bonds is about 4 years, while mortgage contracts run for about 40 years. The shorter the maturity of borrowing, the more often banks must refinance outstanding mortgages, which makes Swedish banks relatively vulnerable in this respect. The audit indicates that regulation of banks does not deal with the risks that large differences in maturities between banks' lending and borrowing may entail.

The audit shows that covered bonds to some extent have replaced the role played by government bonds, since the supply of government bonds is limited. When the pension companies increased their holdings of covered bonds they became more important in financing the banks. The development shows that banks and pension companies are more dependent on a functioning market in covered bonds than before. Thus the need for supervision of banks' issuance of these bonds has increased further.

Protection of priority rights is dependent on valuation rules

The Government and FI have not paid attention to the similar purpose of protecting the special priority right of pension savers as well as of investors. In both cases, supervision is more difficult due to the lack of quoted prices on which FI can base its assessment of the value of pension liabilities and underlying collateral in the cover pool. The audit shows that FI has been considerably more active in regulating how pension companies are to value pension liabilities than regulating how banks are to value collateral in the cover pool.

Methods for valuing pension liabilities are based on assumptions about the future

When FI introduced market valuation to calculate the present value of pension liabilities in 2006 the purpose was to improve matching between pension companies' assets and liabilities. But the regulatory framework did not function as intended. There were no relevant rates for calculating liabilities, since maturities on market-listed bonds are considerably shorter than the duration of pension liabilities. FI had received consultation responses stating that poor supply of bonds as regards volume and maturity, combined with the significance of the pension companies in the capital market, could have negative effects.

The audit shows that FI's calculation method did not function as intended during the crisis when the need for fair valuation of pension liabilities was greatest. At times of market turbulence the method gave very volatile debt values, which required large surpluses at the companies. FI's method, in combination with a limited supply of bonds, led to falling yields and increasing pension liabilities, which reduced the necessary surpluses. Between 2010 and 2011 the companies estimated pension liabilities increased by SEK 245 billion. According to the Swedish NAO, such large fluctuations create uncertainty as to what debt values can be regarded as reflecting the pension companies' commitment to pay out guaranteed pensions, which in turn makes it more difficult for FI to assess the size of assets required to cover the liabilities.

FI was aware at an early stage of the weakness of the calculation method and changed its regulations several times. According to FI, the method introduced at the end of 2013 was a reasonable balance between the use of market rates and a model-based rate that was set at 4.2 per cent and that is significant when there are no market rates that correspond to the debt maturities. The new method would reduce the problem of shortage of long-term rates but could increase the risk of undervaluation of the liabilities. It shows that it continues to be difficult to value pension liabilities, since current rules are also dependent on assumptions about the future.

Furthermore, the audit shows that FI's regulation amendments have mainly led to lower valuation of pension liabilities, which has weakened the priority right for pension savers in general, even though it may differ somewhat between companies. Relaxations in the regulations may be warranted if temporarily low yields lead to revaluation of pension liabilities. But yields have shown a downward trend since 2006. This has made it more difficult to achieve a yield that covers the pension companies' guarantee levels. At the same time relaxations of the regulations gave the companies scope for higher risk-taking, which enables yields from other assets than bonds. The increased dependence of the pension companies on risk buffers in the form of surplus and return on riskier assets also increases the need for in-depth supervision.

Flexible valuation rules make the protection of investors' priority rights more difficult

When the Covered Bonds Issuance Act was introduced in 2004 banks issuing covered bonds were given greater latitude. When drawing up the Act, several references were made to the banks' practice and FI has made some adaptations to practice in its regulations. According to the Swedish NAO, this facilitates the banks' issuance of covered bonds but weakens the protection of the investors' priority right.

According to FI, clearer rules and effective supervision would make covered bonds safer for investors when the regulations were changed in 2013 (*FFFS 2013:1)*. They would improve guidance for issuing banks and the independent inspectors who by law are to help FI in the special supervision of covered bonds. At that time requirements were introduced for the banks to assess their resilience and ability to finance their activities in the event of major falls in housing prices through sensitivity analyses. FI made an addition, allowing the banks to review valuations and underlying collateral in the cover pool, but did not further clarify methods for valuing these collateral.

The audit shows that the flexibility allowed by the regulations that is shown in the independent reports of the inspectors, makes FI's assessments of the quality of the cover pool and the banks' sensitivity analyses more difficult. The Swedish NAO notes that this is in contrast to FI's detailed regulation of the method of valuing pension liabilities.

FI tried to manage risks at banks by regulating pension companies

The Riksbank and FI have repeatedly highlighted the risks of the considerable differences in maturities between the banks' lending and borrowing. When FI changed the calculation method for pension liabilities (*FFFS 2008:23*) the purpose was also to increase demand for covered bonds. According to FI, it would benefit the banks' financing and could lead to issuance of bonds with longer maturities. The Swedish NAO notes that FI tried to manage risks at banks through regulations for pension companies, instead of directing the regulations at the banks.

FI's supervision needs to meet the need to protect priority rights

Even under normal circumstances, it is a demanding task to oversee the special priority rights of pension savers and investors in covered bonds. The area is complex and covers large parts of the financial system. Supervision is essential, since these areas are not covered by any central government guarantees. When the crisis came, the need for supervision increased and the FI's workload grew. According to the Swedish NAO, prioritising increased reporting and stress tests from the pension companies or receiving the independent inspectors' reports on the issuing banks is not sufficient. The audit shows the need to increase supervision on site of the pension companies and issuing banks.

FI needs to give priority to in-depth investigations at pension companies

During the audit period FI increased its supervision by requesting more reporting from the pension companies. FI was aware that the market valuation did not always reasonably reflect underlying values. These circumstances affected the key ratios of the pension companies and the results of FI's stress tests (Traffic Light model). According to the Swedish NAO, this made it more difficult for FI to assess whether the assets were sufficient to cover the actual commitments of the pension companies to pay out guaranteed pensions. The Swedish NAO notes that FI did not make any in-depth investigations of the companies' compliance with the legal requirement for sufficient liquidity and sufficient expected return. Despite the fact that deficiencies were discovered, FI only conducted investigations into how the companies handled the liability coverage registers to a limited extent.

The Swedish NAO welcomes the fact that in 2015 FI intensified its supervision and investigated how the companies manage risks with low interest rates and the return they need to meet promised payments.

Special supervision of covered bond issuance needs to be a priority

FI increased its supervision of the banks but did not give priority to supervising investors' priority rights, despite requirements for special supervision in the Covered Bonds Issuance Act. The audit shows that FI has devoted more resources to analysing household indebtedness and the mortgage market than to analysing the banks' cover pool with reference to quality and loan-to-value ratios. This is despite the banks' dependence on financing through covered bonds to maintain mortgage lending to households.

The independent inspectors are to help FI in supervising the issuing banks. FI has received annual reports from the inspectors. The Swedish NAO notes that it has been difficult to determine what assessments the inspectors have made and how they arrived at their findings. FI has not made any regular assessments of the reports or supplemented them with their own investigations of the banks' handling. The contents of the reports have not made it possible to make an analysis at aggregate level of the trend of all the banks' handling of covered bonds. The Swedish NAO notes that FI's supervision has not been in relation to the fact that special supervision is fundamental to investor protection and market confidence in covered bonds. Thus the supervision is important for the stability of the financial system.

In the course of the audit, FI initiated a supervisory project to develop the special supervision of covered bonds and took measures in 2015. In the opinion of the Swedish NAO, this will provide good conditions for dealing with the deficiencies that emerged during the audit.

Recommendations to the Government

Ahead of the decision in the Riksdag on financial regulation aimed at consumer protection, the Government should ensure that the reference documents include analyses of how demand for bonds and other securities can be influenced and the risks this may entail.

To learn from the crisis, the Government should initiate an evaluation of the effects that regulation and other state measures have had on the pension companies in their role of counterparties in the issuance of bonds by the State and the banks. The evaluation should pay particular attention to any conflicting objectives.

The Government should review the Covered Bonds Issuance Act (2003:1223), focusing on strengthening the protection of investors' priority right. In response to the banks' credit expansion a review should be made of the need to reduce the banks' latitude when issuing such bonds; for example large differences in maturities between lending and borrowing and the terms of loans for tenant-owner rights.

Recommendations to Finansinspektionen (the Swedish FSA)

FI should take into account the similar supervisory remit for pension savers' and investors' priority rights so that experiences and development of methods by FI in regulation and supervision in one of these areas can benefit the other area.

FI should give priority to assessing the quality of the assets. For the pension companies it may concern holdings in unlisted companies that tend to increase when companies seek riskier assets to compensate for low yields on bonds. At the banks, FI should also analyse the composition of the cover pool, as the share of lending to tenant-owner rights has probably increased, which can increase vulnerability in the event of a fall in housing prices.

When the day-to-day supervision that is based on reported data is not sufficient, FI should develop strategies for comprehensive on-site supervision of the pension companies and banks to protect the special priority rights. Such strategies can facilitate consistent action when the need for supervision increases at times of market unrest or other problems.

FI needs to assess the economic capacity of pension companies to manage low interest rates and the extent to which pension companies can become dependent on using risk buffers in the form of surplus to meet guarantees to existing pension savers.

FI needs to clarify how the independent inspectors' work is to be integrated into FI's special supervision of covered bonds and how the inspectors are to implement and report their remit to FI. This also concerns how the special supervision is to be coordinated with bank supervision in other respects, for example of the banks' capacity to increase the cover pool and at the same time maintain sufficient liquidity in the event of a fall in housing prices or other market unrest.