

# MEMORANDUM



Date **08/09/2014**

FI Ref. 14-6258

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## Capital requirements for Swedish banks

### Summary

Experience from the latest financial crisis resulted in intense efforts to strengthen the capitalisation of the international banking sector. In 2009, the G20 countries reached a global agreement regarding measures to improve the capitalisation of banking systems. Finansinspektionen (FI) is now taking a further step in the lengthy decision-making process that has been required to implement the agreement. The Swedish authorities concerned were already in agreement to further tighten capital requirements for Swedish banks, beyond the internationally agreed levels. The positions presented by FI aim to ensure that the Swedish banking system stands more robustly equipped to withstand future financial crises.

On 26 June 2014, Swedish Parliament decided on laws regarding strengthened capital adequacy rules. The new rules of law mainly entered into force on 2 August 2014. FI has been authorised to decide on several matters which, on the whole, have a major influence on the capital requirements of banks. FI is now describing how the capital requirements will be devised.

The information provided by FI can be summarised as follows:

- The four major Swedish banks are assigned a systemic risk buffer of 3 per cent in common equity Tier 1 capital as of 1 January 2015, and a further 2 per cent in a common equity Tier 1 capital requirement within the framework of Pillar 2, which is in accordance with the agreement between the Riksbank, the Swedish Ministry of Finance and FI regarding higher capital requirements for systemically important banks (the so-called November Accord from 2011).
- FI is raising the risk weight floor for Swedish mortgages to 25 per cent (from 15 per cent currently).
- Finanstilsynet in Norway has tightened risk weight requirements for Norwegian mortgages FI will therefore, in the framework of Pillar 2, introduce a risk weight floor for Norwegian mortgages of 25 per cent, like the risk weight floor for Swedish mortgages. The level may need to be adjusted somewhat following discussions with the firms in question.

- FI implements the supervisory capital assessment in Pillar 2, i.e. the assessment of the individual capital requirement of firms, such that a capital requirement under Pillar 2 is always additional to the capital requirement according to the general capital requirements under Pillar 1. However, FI does not normally intend to make a formal decision on the capital requirement under Pillar 2. Insofar that a formal decision has not been made, the capital requirement under Pillar 2 does not affect the level at which the automatic restrictions on distributions linked to the combined buffer requirement come into effect.

FI has submitted a proposal for a regulation in which the countercyclical buffer rate is set at 1 per cent for Sweden. The decision about the regulation is taken in connection with the decision on the positions in this memorandum. In the consequence analysis of the memorandum, consideration has been given to the regulation regarding the countercyclical buffer rate.

On the whole, the implementation of the strengthened capital adequacy rules involves a clear tightening of capital requirements for Swedish banks, particularly the systemically important major banks. The total own funds requirement of the four major banks is estimated to vary between 19.0 and 24.3 per cent, and the total common equity Tier 1 capital requirement is estimated to vary between 14.7 and 19.0 per cent.<sup>1</sup> In FI's opinion, the Swedish banks will be able to meet the requirements. At the same time, because of the need for continuing adaptation, certain banks need to be conservative in their capital planning and show restraint in measures that weaken their resilience, such as profit distribution and share buybacks.

At the same time, it can be ascertained that international efforts to further strengthen the capitalisation of the banking system are progressing. For example, a leverage ratio measure will be introduced, potentially as a compulsory requirement as of 2018. The Basel Committee is also working on preparing proposals to standardise risk weight calculations with the aim of limiting the disparities between the internal models of different banks. Another important aspect is how the EU's crisis management directive will be implemented and applied, since it might involve requirements being placed on the loss-bearing capacity a systemically important bank must have in the event of it succumbing to resolution.

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<sup>1</sup> The estimate is based on a number of assumptions, which are described in the consequence analysis in section 7.

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# 1 Introduction and background

## 1.1 Purpose

An important conclusion from the latest financial crisis is that much more capital is needed in the banking sector. This memorandum describes Finansinspektionen's (FI) position for several of the capital requirement provisions on which FI is authorised to decide. A common factor of the matters included herein is that they are of great importance to the total own funds requirement of the firms, and that implementation does not primarily occur through regulations, but through decisions or practice. The matters include the implementation of the November Accord, as it is known. That is, the agreement between the Riksbank, the Swedish Ministry of Finance and FI regarding new capital requirements for Swedish banks, published in November 2011.<sup>2</sup>

The questions addressed are the size of the systemic risk buffer, reciprocity between countries for the countercyclical capital buffer and the implementation of the supervisory capital assessment in Pillar 2. In the supervisory capital assessment, FI also needs to take account of systemic risk. This affects the supervisory capital assessment for the most systemically important firms, and the assessment of the capital requirement for exposures to mortgages.

In this memorandum, the term "firm" or "credit firm" is used for all institutions (banks, credit institutions and investment firms) covered by the capital adequacy rules.

## 1.2 Viewpoints and implementation

On 8 May 2014 FI submitted a memorandum containing proposals for positions regarding, besides the systemic risk buffer, reciprocity and the implementation of the supervisory capital assessment, also the countercyclical capital buffer. The viewpoints received by FI are provided in connection with each position. FI decides, at the same time as addressing the positions in this memorandum, also on the regulation regarding the countercyclical capital buffer. The viewpoints received relating thereto are hence not addressed in this memorandum, but in the decision memorandum for that regulation.<sup>3</sup>

The positions described by FI in this memorandum are implemented through different procedures. The matters pertaining to Pillar 2 are implemented in FI's supervision process, and matters regarding buffer requirements are implemented through formal decisions. These processes are described in more detail with respect to each position taken.

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<sup>2</sup> See New capital requirements for Swedish banks, press release on fi.se, 25 November 2011.

<sup>3</sup> FI Ref. 14-7010

## 1.3 Background

### 1.3.1 *The benefit of higher capital requirements*

Compared with other firms, banks and other credit firms have a high level of indebtedness. In other words, their share of equity is low in relation to other funding. It is normally profitable for the owners of such firms to fund their operations using a large share of loans. This is largely due to the Government's implicit and explicit guarantees for the banking system.

Smoothly functioning financial markets are key to the economy. The high debt ratio of credit firms makes them sensitive to shocks and losses. In such situations, there is a risk that the credit firms cannot fulfil their role in the financial system, which can have major negative implications for the economy. At worst, credit firms can fail, resulting in even more severe consequences. It is hence of great public interest that credit firms have sufficient capital to fulfil their commitments, even if they suffer losses.

### 1.3.2 *The Basel 3 agreement and implementation in the EU*

The financial crisis that broke out in 2007 led to powerful initiatives to safeguard financial stability. In a declaration from the G20 meeting in Pittsburgh in 2009, a global agreement was presented regarding measures to improve the capitalisation of the banking system. In December 2010, the Basel Committee on Banking Supervision (the Basel Committee) then issued a new framework for banks, known as the Basel 3 agreement.<sup>4</sup>

The Basel 3 agreement contained a large number of measures to address the difficulties in global financial regulations. The measures were directed at both funding and liquidity risks, and the banks' overly weak capitalisation. In this memorandum, only capitalisation is addressed. In this area, Basel 3 can be summarised most simply as the new rules requiring banks to hold more capital, and for the capital to be of better quality.

The EU has chosen to implement the Basel 3 agreement as binding regulations. In July 2011, the EU Commission presented a proposal for a new directive and a new regulation to replace the previously applicable directives in the area. The Capital Requirements Directive<sup>5</sup> and the Capital Requirements Regulation<sup>6</sup>

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<sup>4</sup> Basel 3: A global regulatory framework for more resilient banks and banking systems, December 2010, and updated in June 2011, [www.bis.org](http://www.bis.org)

<sup>5</sup> Directive 2013/36/EU of the European Parliament and of the Council of 26 June 2013 on access to the activity of credit institutions and the prudential supervision of credit institutions and investment firms, amending Directive 2002/87/EC and repealing Directives 2006/48/EC and 2009/49/EC.

were adopted by the European Parliament and the European Council on 26 June 2013 and came into effect on 1 January 2014.

### ***1.3.3 EU harmonisation and national measures***

The Capital Requirements Regulation fundamentally comprises what is known as fully harmonised rules. According to full harmonisation, individual Member States may not apply rules that are either less strict or more strict than those specified in the EU regulations. The ban on applying stricter rules differs from the Basel agreements, which are agreements on minimum rules. The purpose of fully harmonising the rules within the EU is to promote the EU's single market for financial services. In order for the competent authorities of each EU country to nevertheless be able to adapt the capital requirements to the level of systemic risks (sometimes known as macroprudential risks) in the country, and to the risk in individual firms, there are however certain specific provisions containing both possibilities and obligations to apply stricter rules.

In the EU negotiations preceding the adoption of the Capital Requirements Directive and the Capital Requirements Regulation, Sweden represented a line that entailed the individual Member States having the possibility of applying stricter capital requirements if they deemed it necessary to safeguard the country's financial stability. These viewpoints also gained the support of the Council and the European Parliament. According to the line of negotiation, a need was recognised to balance the desire to harmonise regulations to promote the single market, and the need to promote financial stability by having the possibility, at national level, to address country- and firm-specific risks.

Part of the background to Sweden's line of negotiation was the previously mentioned November Accord, which entailed the major Swedish banks having higher capital requirements. In connection with the presentation of the Accord, it was pointed out that the Swedish banks were very large in relation to the Swedish economy and that they largely obtain funding on international capital markets. This state of affairs was considered to pose particular challenges to upholding financial stability in Sweden.

The specific possibilities and obligations of the EU regulations to apply stricter rules, in order to adapt the capital requirement to the level of systemic risks in the country and to the risk in individual firms, presuppose that an authority is appointed to assess the level of such risks. In Sweden, FI has been appointed by the legislator to make such assessments and the ensuing decisions.

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<sup>6</sup> Regulation (EU) No 575/2013 of the European Parliament and of the Council of 26 June 2013 on prudential requirements for credit institutions and investment firms and amending Regulation (EU) No 648/2012.

## 1.4 The components of the capital requirement

The own funds requirement in the new regulations consists of several different components. A brief and general overview of the components is provided in this section. More details are provided in the other sections of the memorandum.

First, like before, there is a *minimum capital requirement* calculated according to the detailed rules specified in the Capital Requirements Regulation. This capital requirement always amounts to 8 per cent of the firm's risk-weighted exposure amount.

On top of this, the new Capital Requirements Directive introduces a new type of capital requirement that was not in the former regulations; that is, a number of buffer requirements. The buffer requirements consist of five different buffers:

- *The capital conservation buffer* amounts to 2.5 per cent of risk-weighted assets and applies to all firms.
- The level of the *countercyclical capital buffer* is determined at national level by a designated authority as regards credit exposures for each country.
- In addition, there are three systemic risk buffers; *the systemic risk buffer*, *the capital buffer for global systemically important institutions* and *the capital buffer for other systemically important institutions*. Which firms are to be covered by the systemic risk buffers, and the level of these buffer requirements, are primarily determined at national level and can hence vary between the firms.

Finally, the competent authority, in the same way as before, shall perform an individual supervisory capital assessment of each individual firm. The extra own funds requirement ensuing from this assessment is called the *specific own funds requirement* in the regulation, but is often called the capital requirement according to *Pillar 2*, compared to the previously described capital requirements, which are often called capital requirements according to *Pillar 1*.

## 1.5 Overarching legal basis

The EU has implemented the Basel 3 agreement as binding regulations through the Capital Requirements Regulation and the Capital Requirements Directive.

The Capital Requirements Regulation contains prudential requirements which the firms covered, i.e. credit institutions and investment firms, must fulfil. It is hence a case of requirements that the firms must fulfil in terms of capital, liquidity, major exposures, leverage ratio and reporting. In the Capital



Requirements Regulation, possibilities have also been introduced for Member States or competent national authorities to use a number of specific macroprudential measures to counteract systemic risks at national level. The Capital Requirements Regulation is directly applicable in Sweden; that is, as Swedish law as soon as it has come into effect without needing to take any measures to implement it.

The new Capital Requirements Directive contains provisions about the methods of competent authorities to conduct supervision of firms, corporate governance matters, demands on firms' risk management systems, sanctions in the event of breaches of the regulations and provisions regarding capital buffers.

The Capital Requirements Directive is, unlike the Capital Requirements Regulation, not directly applicable in Sweden, but must be implemented in Swedish law. On 26 June 2014, Swedish Parliament decided on the laws regarding strengthened capital adequacy rules through which the directive is implemented in Sweden, the Special Supervision of Credit Institutions and Investment Firms Act (2014:968) – the supervision act, and the Capital Buffers Act (2014:966) – the buffer act. In turn, these laws contain an authorisation for the Government or the authority designated by the Government to issue regulations. In the laws, it is also set out that FI is the competent authority. It is in light of this that FI's positions in this memorandum should be seen.

The European Banking Authority (EBA) is given, through the Capital Requirements Directive and the Capital Requirements Regulation, the assignment of preparing proposals for binding technical standards in certain areas that are to be adopted by the EU Commission before coming into effect. Once these technical standards have been adopted by the Commission and come into force, they will have the same binding effect as law in Sweden. In addition, the EBA and, in certain rare cases the European Systemic Risk Board (ESRB), will be given the possibility of issuing guidelines and recommendations. EBA's guidelines and recommendations are not legally binding, but national supervisory authorities and the institutions covered shall "make every effort to comply with them".<sup>7</sup> FI finds that guidelines from the European supervisory authorities addressed to competent authorities or financial market participants are equivalent to Swedish general guidelines.<sup>8</sup>

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<sup>7</sup> Article 16.3 of Regulation (EU) No. 1093/2010 of the European Parliament and of the Council of 24 November 2010 establishing a European Supervisory Authority.

<sup>8</sup> The implementation of the European supervisory authorities' guidelines and recommendations, memorandum published on fi.se on 18 February 2013, FI Ref. 12-12289.

## 2 The supervisory capital assessment in Pillar 2

### 2.1 Introduction and background

#### 2.1.1 Introduction

This section aims to describe FI's positions in a number of fundamental matters pertaining to the implementation of the rules governing FI's supervisory review and evaluation of the risks and capital requirements of individual firms – the supervisory capital assessment. This takes place within the framework of Pillar 2.

Going forward, FI intends to publish further documents on matters regarding Pillar 2. These will be guidance documents pertaining to firms' internal capital adequacy assessment process, and documents that refer to FI's more detailed methods to assess individual types of risk in the framework of the supervisory capital assessment. (For an explanation of the various terms, see section 2.1.2.)

#### 2.1.2 General information about Pillar 2

Pillar 2 supplements the capital requirement calculations regulated in detail in the Capital Requirements Regulation, which are often called Pillar 1. Pillar 2 is the umbrella term for the rules governing firms' *internal capital adequacy assessment process*, and FI's *supervisory review and evaluation process*, of which FI's *supervisory capital assessment* forms an important part.

The positions taken by FI in this section pertain to the part of Pillar 2 that constitutes FI's supervisory capital assessment. The positions will also reasonably affect how the firms choose to devise their internal capital adequacy assessment process.

Each firm subject to the capital adequacy rules must complete an internal capital adequacy assessment process. This must be performed at both the individual and consolidated level; that is for the firm itself and for the group to which the firm belongs. It must also be revised regularly to be kept up to date. The purpose of the evaluation is to highlight the risks to which the firm is or could become exposed, how such risks are managed and hence the capital required by the firm. FI's supervisory review and evaluation process includes an assessment of the firm's internal capital adequacy assessment process.

FI's supervisory capital assessment is based on a comprehensive analysis of the firm. Besides assessing the extent to which the firm needs to hold extra capital to cover risks or risk elements not covered by Pillar 1 (henceforth, this extra capital is referred to as the *Pillar 2 basic requirement*), FI also performs an assessment of the firm's need to hold a so-called *capital planning buffer*. In special cases, the Pillar 2 basic requirement can also include an extra own funds requirement for deficiencies in arrangements, processes and procedures.

### **2.1.3 Scope of the regulations**

The rules apply to all firms covered by the capital adequacy regulations, irrespective of size. This applies both at the individual and consolidated level. The positions taken in this section regarding individual firms therefore also apply at consolidated level for the groups in question.

FI's supervisory review and evaluation process, which includes the supervisory capital assessment, is for the very largest groups much more thorough and comprehensive than it is for the smaller firms. For the largest groups and firms, a supervisory capital assessment is conducted at least once a year. For most smaller firms and groups, however, the supervisory capital assessment is conducted less frequently, insofar there is no indication of material risks to ongoing financial robustness or deficient compliance with regulations. The same applies at the individual level for most of the firms that form part of large groups.

## **2.2 Fundamental legal basis**

### **2.2.1 EU legal regulation**

The rules regarding Pillar 2 can be found in Articles 73–110 of the Capital Requirements Directive.<sup>9</sup> The Capital Requirements Directive, unlike the Capital Requirements Regulation, is not in direct effect in Sweden, but must be implemented in Swedish law. In the sections of the memorandum that address the legal basis for implementation of Pillar 2 in Sweden, reference is therefore made to the new laws – the supervision act and the buffer act.

### **2.2.2 Swedish law**

The provisions of the Capital Requirements Directive regarding Pillar 2 are implemented in Swedish law through Chapter 2 of the supervision act, Chapter 6, sections 1–3, 4a–b and 5 of the Banking and Financing Business Act (2004:297) – the BFBA, Chapter 8, sections 3–8 of the Swedish Securities Market Act (2007:528) – the SMA, and a Special Supervision and Capital Buffers Ordinance (2014:993) – the prudential requirements and capital buffers ordinance.

The provision regarding a specific own funds requirement, Chapter 2, section 1 of the supervision act, gives FI the right to decide that a firm shall have an own funds requirement in excess of the minimum level that otherwise applies (that is, on top of what is required by the Capital Requirements Regulation and the buffer act). FI has the right to decide on a specific own funds requirement if FI, in conjunction with a supervisory review and evaluation, sees a need to cover risks to which the firm is or could become exposed, and risks that the firm

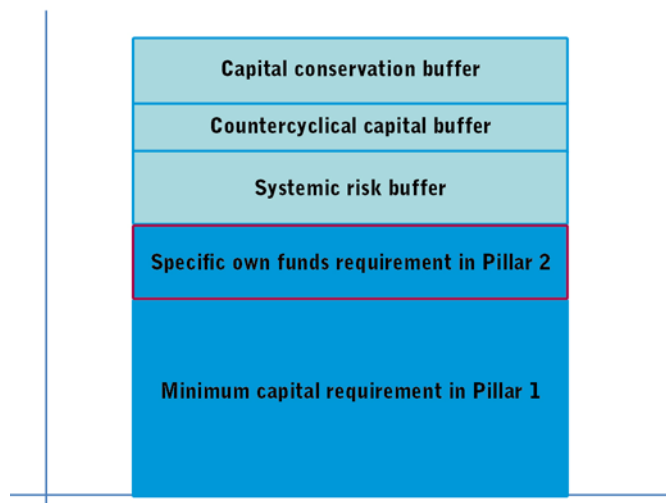
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<sup>9</sup> Pillar 2 is not used as a formal concept in the EU regulations. It is a term introduced and used by the Basel Committee on Banking Supervision.

poses to the financial system.<sup>10</sup> Decisions regarding a specific own funds requirement can also be taken if the firm does not meet the requirements of Chapter 6, section 1–3, 4 a, 4 b and 5 of the BFBA regarding e.g. equity/assets ratio and liquidity, risk management and transparency, or equivalent provisions of the SMA (Chapter 8, sections 3–8 of the SMA).

The aforementioned provision in Chapter 2, section 1 of the supervision act expresses that a formally decided specific own funds requirement is additional to both the minimum capital requirement and the capital buffers. Furthermore, in Chapter 2 section 2 of the same law, it is expressed that a firm that does not meet the capital requirements according to the Capital Buffers Act, but that meets other capital requirements (Pillar 1 and specific own funds requirements under Pillar 2) can be subjected to certain interventions. Hence, in other words, the specific own funds requirement involves an increase to the minimum capital requirement and hence pushes the combined buffer requirement upwards, as in diagram 2.1 below.<sup>11</sup>

### 2.1 How the specific own funds requirement stands in relation to minimum capital requirements and buffer requirements in Pillar 1 in the supervision act



In diagram 2.1 above, and also henceforth in this section, the three different systemic risk buffers – the buffer for global systemically important institutions, the buffer for other systemically important institutions and the systemic risk buffer – are illustrated as one combined buffer which, in this section, is called the systemic risk buffer. The size of the buffer, as depicted in the diagram, should not be seen as an indication of actual implementation. How the three systemic risk buffers work, and how they will be implemented in Sweden, is instead described in Chapter 3. That scope of the specific own funds requirement under Pillar 2 in the diagram is merely an example and should not

<sup>10</sup> FI's supervisory review and evaluation process is more closely regulated in the prudential requirements and capital buffers ordinance.

<sup>11</sup> See section 7.2.11 of the bill for the supervision act and buffer act, prop. 2013/14:228.

either be considered indicative of the actual scope, which varies between firms and over time. The same applies to the size of the countercyclical capital buffer.

### **2.2.3 EBA's guidelines**

In Article 107.3 of the Capital Requirements Directive, EBA is given the task of issuing guidelines to the national supervisory authorities with a view to specifying the common procedures and methods for the supervisory review and evaluation process. On 7 July, the EBA published a proposal for consultation on its website.<sup>12</sup> The guidelines must be complete no later than 31 December 2014.

Furthermore, EBA has, through Article 8.1 of the regulation governing the operations of the authority<sup>13</sup>, been given the task of preparing a European supervision manual regarding the supervision of financial institutions in the EU. This manual too will have a certain effect on how FI's supervisory review and evaluation process is devised, and EBA intends to complete an initial version of selected parts of the manual in 2014.

## **2.3 General information regarding FI's positions**

### **2.3.1 Positions in relation to EU law**

The EU regulations and the Swedish law and ordinance governing Pillar 2, and which were generally described in section 2.2, set out the fundamental principles for Pillar 2, including FI's powers. At the same time, the Capital Requirements Directive (and, in accordance therewith, the supervision act) provide a certain amount of scope for FI, and the other national supervisory authorities, to devise the supervisory review and evaluation process, including the supervisory capital assessment, in practice. However, this scope will be further limited by the guidelines being prepared by the EBA on the area. FI participates actively in work with the EBA's guidelines, and hence has the ability to be involved and influence their content. In FI's opinion, the positions set out in this memorandum coincide with the EBA's proposal for guidelines currently under consultation.

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<sup>12</sup> See *Consultation on guidelines for common procedures and methodologies for the supervisory review and evaluation process (SREP)* (EBA/CP/2014/14) on eba.europa.eu.

<sup>13</sup> Regulation (EU) No. 1093/2010 of the European Parliament and of the Council of 24 November 2010 establishing a European Supervisory Authority (European Banking Authority), amending decision no. 716/2009/EC and repealing the Commission's decision 2009/78/EC. See also Regulation (EU) No. 1022/2013 of the European Parliament and of the Council of 22 October 2013 amending Regulation (EU) No. 1093/2010 establishing a European Supervisory Authority (European Banking Authority), in terms of bestowing special tasks on the European Central Bank in accordance with the Regulation (EU) No. 1024/2013 of the Council.

If, contrary to expectations, it emerges when EBA's guidelines have been completed, that the positions reported by FI do not coincide with the final guidelines, FI will be prepared to review how its processes are devised.

### **2.3.2 Areas affected**

FI has identified five areas that pertain to the implementation of the Pillar 2 regulations, in which FI finds that there is a need to clarify how FI intends to conduct the supervisory capital assessment. FI's positions in these five areas have, on the whole, a substantial effect on the level of capital firms will need to hold on top of the Pillar 1 requirements. The five areas are:

- Fundamental method selection for FI's assessment of the Pillar 2 basic requirement
- Assessment of the capital planning buffer
- The Basel 1 floor, Pillar 2 basic requirement and the capital planning buffer
- Type of capital
- FI's decision-making

In the following sections, FI's position in each area is described, along with the legal basis and the reasons for FI's position. Some sections also include certain clarifications about practical implementation. Finally, it is described how FI will contribute to improved transparency of the supervisory capital assessment in Pillar 2.

## **2.4 Fundamental method selection for the assessment of the Pillar 2 basic requirement**

### **2.4.1 Introduction to the matter**

The legislation provides scope for FI to devise the methods that are to form the basis of FI's supervisory capital assessment in Pillar 2. FI's assessment of the firm's aggregated risk level is decisive for the size of the pillar 2 basic requirement. The following section describes FI's view of how the capital requirements for individual risks are to be weighed together. It affects in particular the assessment of risks also covered by Pillar 1.

The more detailed assessment of the risk level for the individual risk areas, which is implemented in the supervisory capital assessment, is not covered by this memorandum. Ahead however, FI intends to separately submit the first of several planned methodology documents regarding individual types of risk. This forms part of FI's overarching ambition to make the supervisory capital assessment more transparent by clarifying the assessment criteria.

### 2.4.2 *FI's position*

The risks covered by the Pillar 2 basic requirement are always *additional* to the risks covered by Pillar 1. Hence, an individual risk will never be considered lower than specified by Pillar 1. In addition, the risks or risk elements not covered by Pillar 1 are added.

### 2.4.3 *Feedback received*

**Kommuninvest** expresses that there is a major risk of subjective judgements in light of the fact that FI writes that FI can judge that the firm's internal capital adequacy assessment process meets the requirements imposed by the regulatory framework while, at the same time, FI does not accept the firm's conclusion regarding the level of capital need. Kommuninvest expects FI to clarify its assessment criteria in time.

**The Swedish National Savings Banks Organisation** would like to have more detailed descriptions of FI's methods for assessing the overall capital need of firms and guidance documents regarding Pillar 2.

### 2.4.4 *Legal basis*

FI shall, according to Chapter 2, section 1 of the supervision act decide that, in certain circumstances, a firm shall meet a specific own funds requirement *in addition to* what is required by the Capital Requirements Regulation and the buffer act.<sup>14</sup>

Furthermore, the Government, or the authority appointed by the Government in Chapter 10, section 2, point 4 of the supervision act, is authorised to issue regulations regarding the circumstances to be duly considered in establishing a suitable own funds level in connection with a supervisory review and evaluation of a firm. By reason thereof, it follows that section 9 of the Special Supervision and Capital Buffers Ordinance (2014:993) – the prudential requirements and capital buffers ordinance, that FI, in its supervision, shall follow the provisions regarding the supervisory review and evaluation process in Articles 97–101 of the Capital Requirements Directive.

The ordinance consequently regulates which areas FI is to assess within the framework of the supervisory review and evaluation process. However,

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<sup>14</sup> Furthermore, it is noteworthy that, according to Article 104.1.d of the Capital Requirements Directive, competent authorities can also require firms, in connection with own funds requirements, to apply a specific provisioning policy or specific treatment of assets. This is accommodated according to page 222 of prop. 2013/14:228 within FI's powers to order firms to take various types of measures in e.g. Chapter 15 of the BFBA.



nothing is mentioned about which method is to be used in the assessment. It is hence up to FI to decide on that matter.<sup>15</sup>

#### **2.4.5 *Reasons for FI's position***

It is clear from the legal basis that FI has the power to impose a specific own funds requirement on a firm, and that the assessment of the size of the specific own funds requirement is to be based on FI's supervisory review and evaluation process. This process involves a review of all substantial risks to which a firm is or could become exposed, and the risks that a firm poses to the financial system. Because the assessment covers all substantial risks, it covers both the risks not covered and that are covered by Pillar 1. The risks that are only covered in part or not at all by Pillar 1 shall be covered in their entirety by what FI calls the Pillar 2 basic requirement. In FI's opinion, the purpose of the Pillar 2 basic requirement is the same as the purpose of the minimum capital requirement in Pillar 1. The only difference is that, while Pillar 1 is limited to the risks and calculation methods specified in Pillar 1, the assessment of the Pillar 2 basic requirement shall cover all risks and risk elements.

The supervisory capital assessment in Pillar 2 thus covers both the risks that are covered and those that are not covered by Pillar 1. FI finds that it is appropriate that FI, as supervisory authority and issuer of regulations on the area, does not diverge in Pillar 2 either from the risk measurement method prescribed by the regulations (that is, the calculation under Pillar 1) for the risks and risk elements covered by Pillar 1, insofar that Pillar 1 cannot be said to underestimate the actual risk.

#### **2.4.6 *Clarification regarding the internal capital adequacy assessment process***

In contrast to FI, a number of firms choose to manage their own capital need calculation, which is conducted in the internal capital adequacy assessment process, as a separate and parallel calculation in relation to Pillar 1. The final result of such a calculation might hence very well involve both a lower capital need and greater capital than the levels ensuing from Pillar 1. It is particularly prominent for the firms that allow significantly positive effects from diversification.

Part of the supervisory review and evaluation process involves FI assessing the quality of the firms' internal capital adequacy assessment process. FI can consider a firm's internal capital adequacy assessment, that is the firm's *processes* for assessing its risks, to be satisfying despite FI finding that the risks and hence the *capital need* in the Pillar 2 basic requirement are higher than the level concluded by the firm's own calculations to that effect. Hence, FI may, in the framework of the same supervisory review and evaluation process, find that the firm's internal capital adequacy assessment process meets

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<sup>15</sup> As already pointed out, however, EBA has been authorised to issue guidelines.



the requirements imposed by the regulations, while at the same time FI, in its supervisory capital assessment, does not accept the firm's conclusion regarding the aggregate risk level, and hence the capital need level.

Going forward, FI plans to submit a guidance document setting out FI's expectations on the internal capital adequacy assessment process of firms in light of the new capital adequacy regulations and FI's positions regarding the supervisory capital assessment described in this memorandum.

## 2.5 Assessment of the capital planning buffer

### 2.5.1 Introduction to the matter

Besides an assessment of the size of the Pillar 2 basic requirement, the supervisory capital assessment also contains an assessment of the firm's need to hold what FI calls a capital planning buffer. Because the regulations do not prescribe how the size of the capital planning buffer is to be assessed, it is appropriate for FI to clarify its view on this.

The implementation of the Capital Requirements Directive brings new requirements for firms to hold capital buffers under Pillar 1. It therefore needs to be clarified how the capital planning buffer under Pillar 2 stands in relation to the new capital buffers; that is, whether they fully or partially cover the same risk and have the same purpose, and hence fully or partially overlap.

### 2.5.2 FI's position

The capital held by a firm to cover the capital conservation buffer may also be used to cover the capital planning buffer, with the exception of the part that is intended to cover deterioration of the capital adequacy during a *normal recession*.

The capital held by a firm to cover minimum capital requirements and other buffer requirements may, with the exception stated above, not be used to cover the capital planning buffer.

The capital planning buffer shall be of such scope that it covers at a minimum the deterioration of the capital adequacy that may arise *in severe but plausible* financial stress. The size of the buffer is suitably calculated by means of scenario analyses/stress tests that reflect such a scenario.

### 2.5.3 Feedback received

**The Swedish Bankers' Association** is of the view that it should be possible to use all capital buffers to cover the capital planning buffer. It is expressed on p. 137 of proposal 2013/14:229 that the capital buffers shall be viewed as shock absorbers with the primary purpose of institutions avoiding being in breach of

the own funds requirement ensuing from the Capital Requirements Regulation and the Capital Requirements Directive. Hence, the same purpose as the capital planning buffer. FI's interpretation, that the purpose of the buffers for systemic risk and the countercyclical capital buffer is different from the capital conservation buffer, is a far-reaching interpretation. The purpose is the same for all capital buffers.

**The Association of Swedish Finance Houses** finds that all capital buffers can be used to cover the capital planning buffer.

**Kommuninvest** expresses that there is a clear risk of overly subjective grounds for the assessment of the size of a sufficiently large capital planning buffer, and expects FI to clarify its assessment criteria in time.

## **2.5.4 Legal basis**

### *2.5.4.1 The capital planning buffer*

According to Chapter 2, section 1 of the supervision act, a specific own funds requirement shall be imposed when a firm does not fulfil the requirements of e.g. Chapter 6, section 2 of the BFBA, or Chapter 8 section 4 of the SMA. The provision in Chapter 6, section 2 of the BFBA and equivalent provision in Chapter 8, section 4 of the SMA regulate the requirements for firms' internal capital adequacy assessment process, and state that firms shall have introduced sound, effective and comprehensive processes for continuously evaluating and maintaining internal capital which, in its amount, type and distribution, is sufficient to cover the type and level of the risks to which they are or could become exposed.

In the preparatory work for the aforementioned laws, it is stated that the provision entails that firms ought to have introduced strategies and methods to continuously maintain the capital at a sufficient level (prop. 2006/07:5, page 137.).

### *2.5.4.2 The capital buffers in Pillar 1*

The capital buffers are regulated by the buffer act. There are five different buffers – three that are intended to cover systemic risk (the buffer for global systemically important institutions, the buffer for other systemically important institutions and the systemic risk buffer, which together are called systemic risk buffer in the diagrams here), as well as a capital conservation buffer and a countercyclical capital buffer.

The firms are to calculate the extra capital requirement they are to meet by reason of the buffers, known as the combined buffer requirement. If the combined buffer requirement is not maintained, certain specific intervention

measures arise in the form of e.g. restrictions on distributions, see section 2.8.2.2 and Chapter 8 of the buffer act.<sup>16</sup>

The purpose of the capital buffers, as the buffers are described in section 5.3.1 in the bill for the supervision act and buffer act, prop. 2013/14:228, is that it should be possible to use them as temporary shock absorbers to cover losses in downturns and hence prevent firms from breaching the own funds requirements of the Capital Requirements Regulation. This wording is matched to a certain extent by the Capital Requirements Directive, recital 80 in the introduction, which states that the purpose of the capital conservation buffer and the countercyclical capital buffer is to be drawn down *during stressed periods*. In terms of the countercyclical capital buffer, it is also expressed in particular that it should meet a cyclical systemic risk primarily associated with excessive credit growth in the financial system, and that it will hence vary over time.

In section 7.2.9 of the bill, it is stated that the purpose of the systemic risk buffer is to prevent or reduce long-term, non-cyclical systemic risks or macroprudential risks.

## **2.5.5 Reasons for FI's position**

### **2.5.5.1 How the capital planning buffer relates to the buffer requirements in Pillar 1**

The requirement for the firm to *continually* maintain sufficient internal capital involves the firm needing to hold capital in excess of the level entailing all risks and risk elements being covered; that is, on top of the minimum requirement under Pillar 1 and the Pillar 2 basic requirement. FI calls this the capital planning buffer.

Should the firm not hold a sufficient capital planning buffer, it is in breach of Chapter 6, section 2 of the BFBA or Chapter 8, section 4 of the SMA. This constitutes grounds for FI to decide on a specific own funds requirement in accordance with Chapter 2, section 1 of the supervision act.

The capital planning buffer is hence part of the specific own funds requirement if the firm breaches the requirement to hold a sufficient capital planning buffer, but only in that case. This differs from the part of the specific own funds requirement that is based on FI's possibility to decide that a firm is to hold capital to cover risks or risk elements not covered by Pillar 1; that is, the Pillar 2 basic requirement. FI is entitled to make decisions on the Pillar 2 basic requirement, even if the firm has own funds that suffice to cover such risks, see Chapter 2 section 1 of the supervision act.

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<sup>16</sup> Besides the automatic legal consequences, supervisory authorities can consider other supplementary intervention measures, which are set out in law. Such intervention possibilities will be further broadened through the forthcoming implementation of the Crisis Management Directive.

As expressed in the rationale above, the legal basis for the requirement to hold a capital planning buffer differs from the basis of the requirement to hold other Pillar 2 capital – the capital which FI calls the Pillar 2 basic requirement. FI therefore finds that the capital planning buffer should not be considered as a part of the minimum capital requirement, in the way that the Pillar 2 basic requirement is considered, but as the very buffer it is. There is therefore a need to clarify how the capital planning buffer interacts with the buffer requirements specified in the buffer act, namely the capital conservation buffer, the three buffers for systemic risks and the countercyclical capital buffer.

The capital requirement under Pillar 1 and the Pillar 2 basic requirement aim to cover losses that may arise in *highly severe financial stress* and constitute ultimate protection for depositors and other creditors, the government and taxpayers in a situation of the bank risking succumbing to resolution. Because the capital requirement is to be continuously maintained, the firm must hold a buffer so that less improbable losses do not lead to dropping below the capital requirement.

All buffer requirements constitute shock absorbers against the firm breaching the minimum capital requirement insofar that the fact of a firm breaching the buffer requirements does not in itself alone constitute a sufficient reason for FI to be entitled to withdraw the authorisation of the firm, unlike if the firm falls below the minimum capital requirement. FI finds however, that this fact does not imply all the buffer requirements having the exact same purpose. There are other aspects that differentiate them.

The purpose of the capital conservation buffer overlaps with that of the capital planning buffer, because both aim to provide a margin down to the minimum capital requirement. It is thus reasonable that the capital set aside to cover a capital conservation buffer may also be used, at least to a certain extent, to cover the capital planning buffer. In section 5.3.1 of the bill, it is stated that it should be possible to use the capital conservation buffer, similar to the other buffers, as a temporary shock absorber to cover losses in downturns and hence prevent institutions from breaching the own funds requirements of the Capital Requirements Regulation. FI interprets the term “downturns” in light of recital 80 in the introduction of the Capital Requirements Directive, which states that the capital conservation buffer may be drawn down *during stressed periods*. FI finds that the term *stressed period* in this context should be understood as financial stress that goes beyond a *normal recession*. When performing its assessment of capital, FI assumes that the worst year of a normal recession occurs around once every seventh year. If the firm’s earnings do not suffice to cover negative financial stress in such a year, the firm needs to hold capital beyond the capital conservation buffer to cover that.

Although the three buffers that aim to cover systemic risk are not addressed separately from the capital conservation buffer (and countercyclical capital buffer) in terms of the legal consequences that would ensue from a firm falling

below the total buffer requirement, the purpose of these buffers is clearly separate from that of the capital conservation buffer, and also from the purpose of holding a capital planning buffer. The three systemic risk buffers are to prevent or reduce long-term non-cyclical systemic risks or macroprudential risks, which is not the purpose of the capital planning buffer. The assessment of the size of the capital planning buffer does not cover the systemic risks which are to be covered by the three systemic risk buffers. FI therefore finds that the capital held to cover the three buffers for systemic risk may not be used to cover the capital planning buffer.

In recital 80 in the introduction to the Capital Requirements Directive, it is stated that it should be possible to draw down the capital conservation buffer, like the countercyclical capital buffer, during stressed periods. FI finds, however, that the purpose of the countercyclical capital buffer cannot be established supported solely by this. In FI's opinion, even though the reason in the introduction states that it should be possible to draw down the countercyclical capital buffer during stressed periods, because of the fact that the buffer will be determined by FI and vary over time, its purpose cannot be seen as being at parity with that of the capital conservation buffer.

Furthermore, the bill states that the countercyclical capital buffer is intended to meet a cyclical systemic risk primarily associated with excessive credit growth in the financial system (equivalent wording can be found in reason 80 in the introduction to the Capital Requirements Directive). In order for any decision to determine the countercyclical buffer at higher than zero to have the effect intended by the regulations (i.e. an accumulation of capital), the same capital cannot be used to cover the countercyclical capital buffer as for covering the capital planning buffer. This is because the capital planning buffer, to the extent that it exceeds the capital conservation buffer, would otherwise absorb and hence offset the intended accumulation of capital.

#### 2.5.5.2 *Assessment of the size of the capital planning buffer*

Because FI finds that the purpose of the capital conservation buffer clearly overlaps with that of the capital planning buffer, as described above, the calculation of the size of the capital planning buffer may in practical terms be considered as a verification as to whether the capital conservation buffer is sufficiently large for the individual firm; that is, an assessment of whether the firm needs to hold a buffer on top of the capital conservation buffer.

FI is of the opinion that the size of the capital planning buffer should be determined based on the purpose of the buffer, which is to continuously hold a sufficient level of capital. In light of that, the protection that the capital planning buffer provides need not be as strong as the protection that the other capital requirement is to provide. The minimum capital requirement can be described as having the purpose of covering the losses that could arise in *highly severe* financial stress. The scenario that the capital planning buffer is to cover can be described in words as *severe but plausible* financial stress. Such more

regular, recurring financial stress could for example equate to a deep, protracted recession combined with major drops in asset prices.

The capital planning buffer is to serve as protection against declining capital adequacy; that is, against losses and rising risk-weighted exposure amounts, and falling below the capital requirement which could result from that. It hence covers all the risks, and the same risks, as those covered by Pillar 1 and the Pillar 2 basic requirement. In light of that, it might be appropriate to make clear that, by this, the capital requirements directive requires a firm to hold capital to cover the same risks twice.

### **2.5.6 Clarification of the practical implementation**

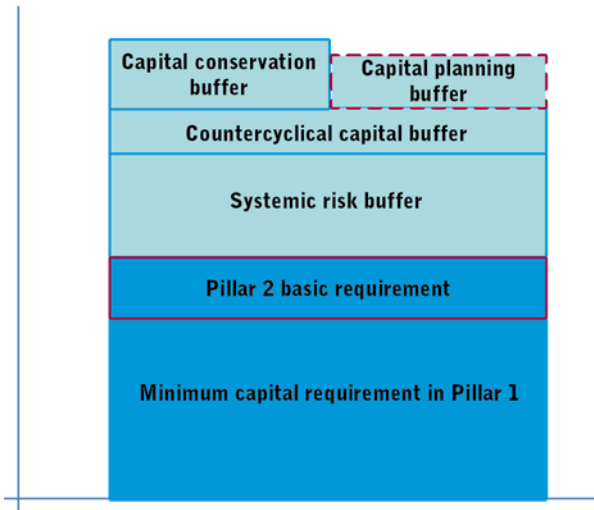
A calculation of the size of a capital planning buffer is often performed by means of a stress test of the firm's income statement, balance sheet and, ultimately, capital adequacy. (Liquidity can also be tested in the same exercise, but that part is not addressed here). The stress test is based on simulating how all material items are affected in *severe but plausible* financial stress. Such a test is suitably tailored to specifically test the weak points of a certain firm, rather than being based on a more general severe scenario. From FI's perspective, however, there are however merits in applying the same scenario to all firms of a certain type, because it facilitates a fair comparison. The scenario should ideally run over the capital planning horizon applied by the firm, which is usually at least three years. In this type of calculation, due consideration should also be given to the firm's earnings capacity. A firm with a high capacity to generate earnings – and perhaps even for a year or so to also generate a profit in a severe but plausible scenario – will thus need less of a capital planning buffer, all else equal. The minimum size of the capital planning buffer is ultimately determined by how much the capital adequacy of the firm deteriorates at the most in the scenario.

In order to ensure that the firm can cope with a *normal recession* without drawing down the capital conservation buffer, the firm also needs to assess how capital adequacy might perceivably be affected in such a scenario. A firm with sound earnings capacity could generate a positive result during a normal recession too, and in such cases the firm does not need to commit any own funds; earnings serve as sufficient protection provided that risk-weighted assets do not increase to an equal extent or more. Firms with slightly weaker earnings capacity may however need to hold a certain level of own funds to cope with the deterioration in capital adequacy that also occurs during a normal recession.

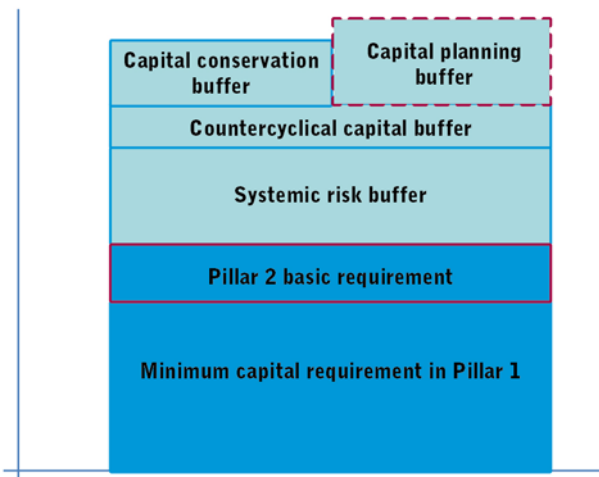
This capital need does not come on top of the capital planning buffer, which is to reflect the capital need during severe but plausible financial stress, but is part of it. However, it must be calculated separately in order to ensure that the firm does not need to draw down the capital conservation buffer during a normal recession.

The diagrams below show two examples of how the capital planning buffer can affect the total capital level of firms.

**2.2 Total capital need with a capital planning buffer that falls below the capital conservation buffer**



**2.3 Total capital need with a capital planning buffer that is above the capital conservation buffer**



In terms of the more detailed assessment criteria regarding the size of the capital planning buffer, FI will clarify these in future, just as that which applies to other parts of Pillar 2. However, FI has chosen to prioritise submitting other parts of the detailed methods for the supervisory capital assessment ahead of the method for assessing the capital planning buffer.



## 2.6 The Basel 1 floor, Pillar 2 basic requirement and the capital planning buffer

### 2.6.1 Introduction to the matter

As FI has already announced, the Basel 1 floor, which comprises the firms authorised to use an internal model to calculate capital requirements, will continue to be applied through 2017.<sup>17</sup> The floor constitutes a back-stop for the lowest level of own funds, and is a capital requirement calculated separately and in parallel. In FI's memorandum on the Basel 1 floor, it was stated that the same capital that covers the new buffer requirements (systemic risk buffers, capital conservation buffer and countercyclical capital buffer) may also be used to cover the Basel 1 floor. However, the memorandum did not describe how the Pillar 2 basic requirement and capital planning buffer stand in relation to the Basel 1 floor. This is not expressly regulated either. There is thus a need for FI to clarify its position in this matter.

### 2.6.2 FI's position

The same capital used to cover the Pillar 2 basic requirement may also be used to cover the Basel 1 floor. The capital that covers the capital planning buffer may not be used to cover the Basel 1 floor, however.

### 2.6.3 Feedback received

**The Swedish Bankers' Association** strongly opposes the view that it should not be possible for the capital that covers the capital planning buffer to cover the Basel 1 floor too. The Bankers' Association expresses that it is clearly set out in the Capital Requirements Regulation, Article 500, that the minimum requirements according to Article 92 and the floor rules are two parallel requirements based on different sets of logic. The floor rules in Article 500 regulate the size of the banks' own funds. The own funds consist by definition, Article 4.1 (118) of the Capital Requirements Regulation, of the sum of an institution's Tier 1 capital and Tier 2 capital. According to the Bankers' Association, it is very clear indeed that the capital used to cover the different buffers, including the capital planning buffer, may be used to cover the Basel 1 floor according to the Capital Requirements Regulation.

### 2.6.4 Legal basis

The Basel 1 floor is regulated in Article 500 of the Capital Requirements Regulation. The provision describes that firms using internal models shall have own funds which, at all times, are at least equal to 80 per cent of the total minimum amount of own funds that the firm would have been obliged to

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<sup>17</sup> See the memorandum Finansinspektionen's approach to the Basel 1 floor. Published on fi.se on 18 March 2014, FI ref. 13-13990.



maintain under the Capital Adequacy Act of 1994, through which the Basel 1 Accord was implemented in Swedish law.

There is no explicit regulation of how the Basel 1 floor stands in relation to the Pillar 2 basic requirement and the capital planning buffer.

### **2.6.5 Reasons for FI's position**

#### *2.6.5.1 Pillar 2 basic requirement*

As already described, the regulations state that the Pillar 2 basic requirement constitutes part of the minimum capital requirement, and the capital covering the Pillar 2 basic requirement cannot be used to cover the combined buffer requirement. The calculation of the floor, on the other hand, is an entirely parallel and separate capital requirement compared with the capital requirement calculation under the main rule.

Because the capital requirement that the Basel 1 floor constitutes is a parallel and separate requirement in relation to the capital requirement calculated using the main rule, and because the Pillar 2 basic requirement is to constitute part of the minimum capital requirement, as it is determined under the main rule, FI finds it reasonable that the Pillar 2 basic requirement should also be calculated separately from and in parallel with the Basel 1 floor. In so doing, it is also clarified that the purpose of the floor is to constitute a back-stop for the total capital level, but that the floor in itself is not a part of the main calculation. See also the examples in diagram 2.4 below.

#### *2.6.5.2 The capital planning buffer*

In the position in section 2.5.2, it is stated that the capital planning buffer will largely be allowed to overlap with the capital conservation buffer. According to the Basel 1 floor, however, certain firms can fall below the floor (which constitutes an absolute minimum capital requirement) before the capital conservation buffer has been drawn down, and certain firms can fall below it before falling below the buffer requirements at all.<sup>18</sup> This is because the floor is not part of the main calculation itself and is rather calculated in parallel, and the buffer requirements under Pillar 1 are hence not additional to the Basel 1 floor.

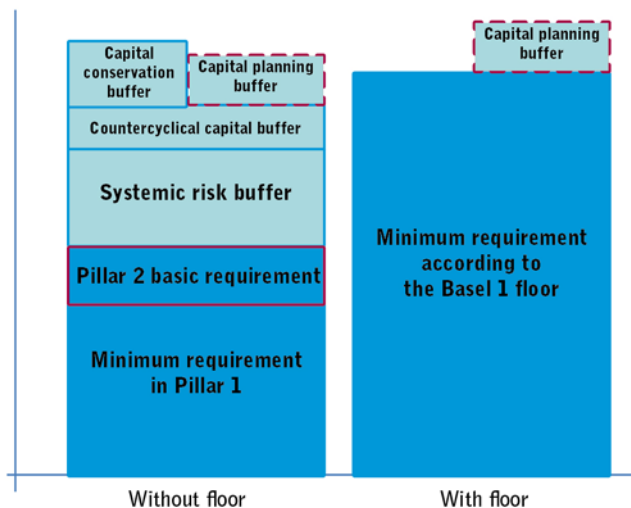
It has also already been established in this chapter that the purpose of a capital planning buffer is that a firm must have a margin on top of the legally binding capital requirement, so that already slight variations in the firm's financial position do not lead to falling below the threshold. FI finds that, because the minimum capital requirement is determined by the floor rule, the natural consequence of the purpose of the capital planning buffer is that it is additional

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<sup>18</sup> See the memorandum Finansinspektionen's approach to the Basel 1 floor. Published on fi.se on 18 March 2014, FI ref. 13-13990.

to the minimum capital requirement – irrespective of whether this requirement is determined in accordance with the main rule or in accordance with the floor. Hence, FI does not share the opinion of the Swedish Bankers' Association that the Capital Requirements Regulation states that the capital planning buffer may be used to cover the minimum capital requirement according to the Basel 1 floor. On the contrary, FI finds that a firm cannot meet the requirement in Chapter 6, section 2 of BFBA or Chapter 8, section 4 of SMA in terms of continuously maintaining sufficient capital if it does not maintain a capital planning buffer in addition to the minimum requirement according to the Basel 1 floor. FI's position in this matter is illustrated by the example in diagram 2.4 below.

#### 2.4 Example of the total capital need of a firm covered by the Basel 1 floor, calculation with and without the floor



##### 2.6.5.3 Clarification of the practical implementation

Section 2.5.5 explains how a capital planning buffer is calculated. It describes, for instance, that such a buffer is to cover both changes to own funds and to the capital requirement. When the capital planning buffer comes on top of the minimum capital requirement, as it is determined according to the Basel 1 floor, the assessment of the size of the capital planning buffer might need to be adapted to this end. This is because financial stress can affect the capital requirement according to the Basel 1 floor differently to how it affects the capital requirement calculated using the main rule.

## 2.7 Type of capital

### 2.7.1 Introduction to the matter

FI may, according to section 11.3.1 of the bill for the supervision act and buffer act, prop. 2013/14:228, impose demands on both amounts and type of capital in

decisions on specific own funds requirements. Therefore, within the framework of decisions regarding specific own funds requirements, FI must take a position on whether the capital requirements under Pillar 2 are to be covered by the forms of capital included in the definition of own funds, and whether all or a certain share should be covered by capital of particularly high quality, such as common equity Tier 1 capital only. Because such matters are of great importance to the firms' capital planning, FI describes its position in this respect.

### **2.7.2 FI's position**

The capital planning buffer is to be covered in its entirety by common equity Tier 1 capital.

The Pillar 2 basic requirement shall as a main rule be covered according to the same allocation of capital as the Pillar 1 capital requirement, including the static buffer requirements (capital conservation buffer, systemic risk buffer and buffers for other and global systemically important institutions).<sup>19</sup>

Divergences from the main rule for the Pillar 2 basic requirement can be made for specific risk types. If this occurs, FI will state this in connection with publishing the method for assessing this type of risk.<sup>20</sup>

Furthermore, in exceptional cases, there may be grounds for FI, in decisions pertaining to individual firms, to opt to diverge from the main capital allocation practice presented herein.

### **2.7.3 Feedback received**

The consulted bodies have not submitted any viewpoints on the position.

### **2.7.4 Legal basis**

Pursuant to Chapter 2, section 1 of the supervision act, FI may impose demands on both amounts and type of capital when deciding on specific own funds requirements, see section 11.3.1 of the bill for the supervision act and buffer act, prop. 2013/14:22.

<sup>19</sup> The systemic risk buffer and buffers for other and global systemically important institutions can be changed through decisions by FI, but the purpose is for them not vary over time, like the countercyclical capital buffer.

<sup>20</sup> This is the case as regards the Pillar 2 basic requirement for Swedish mortgages and for systemic risk, see Chapters 3 and 4 of this memorandum.

## **2.7.5 Reasons for FI's position**

### **2.7.5.1 Pillar 2 basic requirement**

The reason for the position that the Pillar 2 basic requirement should normally be covered by the same capital allocation as in Pillar 1 is that this capital, as a starting point, fulfils the same purpose as the capital requirement under Pillar 1 (see also section 2.4). If divergences are made from the main rule in terms of specific risk types, the reasons for the divergence will be stated in connection with publishing the method for assessing this type of risk.

It is inappropriate, as a main rule, to make an assessment of the required type of capital in each individual case, because this would lead to excessive uncertainty for firms in their capital planning. However, it must be possible to make exceptions to the main rule in certain specific cases. This pertains at least to such cases that concern covering losses already incurred – but which for various reasons have not affected reporting and capital requirements under Pillar 1 – rather than the *risk of losses*. An example of such a case is that, in a review of asset quality, it has emerged that the firm has hidden losses in the balance sheet, i.e. it has made insufficient provisions. In such a case, an additional capital requirement matching the hidden losses could be added in the Pillar 2 basic requirement. Since this capital requirement would reflect actual (although not yet reported) losses, and not just a *risk of losses*, in cases such as and similar to this, it is reasonable for this part only to be covered by common equity Tier 1 capital.

### **2.7.5.2 The capital planning buffer**

There are two main reasons as to why the capital planning buffer must be covered by common equity Tier 1 capital. First, it may be covered by the same capital used to cover the capital conservation buffer which, according to the Pillar 1 regulations, is to consist solely of common equity Tier 1 capital (as specified in section 2.5.2). Second, it is natural for a buffer that is intended, in a situation of financial stress, to be drawn down first of all as losses arise, to be covered by common equity Tier 1 capital because this is the capital that decreases first in the event of losses.

## **2.8 FI's decision-making**

### **2.8.1 Introduction to the matter**

In section 2.5.4 it is expressed that FI can make a formal decision on a firm being obliged to hold a sufficient capital planning buffer if the firm breaches that very requirement, but only in that case. This is not the case in terms of the Pillar 2 basic requirement. FI is entitled to make a decision on the Pillar 2 basic requirement even if the firm has own funds that exceed the capital need for such risks. Furthermore, in an economic sense too, the purpose of the Pillar 2 basic requirement and the capital planning buffer differs. There are hence

grounds to address the Pillar 2 basic requirement and the capital planning buffer in different ways in terms of decision-making.

An alternative to making a formal decision is to inform the firm of FI's overall supervisory capital assessment, without that evaluation constituting a formal decision. Such has been FI's practice to date.

As expressed in section 2.2.2, the specific own funds requirement constitutes an increase to the minimum capital requirement and hence brings up the combined buffer requirement. The capital adequacy level at which automatic restrictions on distributions, linked to falling below the combined buffer requirement, start to apply is not however affected by the specific own funds requirement provided that a formal decision has not been made on this requirement. (Read more in section 2.8.2.2.). There is therefore reason for FI to state in advance how FI intends to manage its decision-making right in terms of the specific own funds requirement.

## **2.8.2 Legal basis**

### *2.8.2.1 About FI's decision-making*

According to Chapter 2, section 1 of the supervision act, FI is empowered, in certain circumstances, to make decisions on a specific own funds requirement. Furthermore, the same provision states that FI may refrain from deciding on a specific own funds requirement, for instance if a breach is negligible or excusable, or if the firm rectifies the matter. In section 11.3.1 of the bill, this decision-making power is described as FI having the *possibility* of making decisions about specific own funds requirements.

### *2.8.2.2 Specific information about restrictions on distributions*

The various capital buffers, known as the combined buffer requirement, infer that a firm shall have common equity Tier 1 capital in addition to the minimum capital requirement and a decision regarding a specific own funds requirement, see Chapter 2, sections 1–2 of buffer act. If a firm does not fulfil the combined buffer requirement, certain bans come into effect, see Chapter 8 of the buffer act.

A firm that does not fulfil the combined buffer requirement may not, according to Chapter 8, section 3 of the buffer act, i) make distributions linked to the firm's common equity Tier 1 capital, ii) undertake to pay out variable remuneration or discretionary pension benefits, iii) make payments on Tier 1 capital contributions. In certain conditions, a firm may nevertheless take such measures that are otherwise prohibited. This presupposes that the firm has calculated a so-called maximum distributable amount, and reported it to FI. The level of the restrictions is determined by the maximum distributable amount.

FI is authorised to prescribe how the maximum distributable amount is to be calculated, see section 18, point 10 of the prudential requirements and capital buffers ordinance. Chapter 9, section 6 of Finansinspektionen's regulations (FFFS 2014:12) regarding prudential requirements and capital buffers states that the calculation of the maximum distributable amount takes account of how large a share of the combined buffer requirement the firm has failed to meet. If a firm can only fulfil the lowest quartile of the combined buffer requirement, the factor is zero, so the restriction is 100 per cent. In the second quartile, the firm may use 20 per cent of its maximum distributable amount, in the third 40 per cent and finally 60 per cent in the fourth quartile.

In particular, the following should be noted. If a formal decision regarding a specific own funds requirement for the firm has not been taken, the calculation of the maximum distributable amount shall be performed without incorporating the Pillar 2 basic requirement and the capital planning buffer. This is because only a formal decision on a specific own funds requirement affects the maximum distributable amount.

Otherwise, according to Chapter 8, section 1 of the buffer act, a firm that does not meet the combined buffer requirement must submit a capital conservation plan to FI showing how it will meet the combined buffer requirement within a reasonable amount of time.

### **2.8.3 FI's position**

FI will not normally make a formal decision on specific own funds requirements. Instead, FI will inform each firm of its supervisory capital assessment of the firm. A formal decision will only be taken in cases where it is deemed necessary.

If a firm falls below the total capital requirement, calculated with account taken of the Pillar 2 basic requirement and the capital planning buffer, also without any formal decision on a specific own funds requirement having been taken, FI will, within the framework of intensified supervision activities with respect to the firm, demand that the latter describes in writing how it intends to restore the capital.

### **2.8.4 Feedback received**

**Sveriges Riksbank** expresses that the Riksbank's overall assessment is that FI should also in normal circumstances make decisions regarding Pillar 2 basic requirements. Although a certain degree of flexibility in situations in which the firm is in financial difficulty might be both desirable and relevant, the Riksbank finds that the benefits of making formal decisions in normal circumstances too outweigh the drawbacks. Furthermore, the Riksbank writes that it imposes demands on FI to be as transparent as possible in light of the fact that such an extensive – and varying between firms – share of the total

capital requirement is within Pillar 2. In order for market discipline to function, it is important that market participants can gain a complete picture of a firm's risk profile. One way of obtaining a better picture of the risks in a firm is that the specific own funds requirement that the firms have been ordered by FI to meet be based on formal decisions. Furthermore, the Riksbank expresses that such a procedure is also positive from a rule of law angle. Incentives might arise for the firms to take greater risks in the hope that FI will refrain from making a formal decision if the risks materialise. The Riksbank sees a risk of this ultimately potentially reducing market confidence in the capital requirements imposed on Swedish firms. The Riksbank also wishes to call attention to the fact that the automatic restrictions ensuing from the buffer act are triggered at lower capital levels in the absence of formal decisions, and in the opinion of the Riksbank it will probably be more difficult to find appropriate ways of restoring capital the lower the capital adequacy of a firm. Finally, the Riksbank expresses that if FI chooses not to change the current decision-making practice, it would nevertheless be desirable if at least parts of the Pillar 2 requirements could be subject to decisions, and this applies in particular to the capital surcharges for systemically important banks and the risk weight floor.

### **2.8.5 *Reasons for FI's position***

#### **2.8.5.1 *FI's decision-making***

In terms of the Pillar 2 basic requirement, there need not be a shortage of capital for FI to be able make a decision regarding a specific own funds requirement. FI finds it most appropriate, however, not to make formal decisions in cases where, in FI's opinion, all risks and risk elements actually have capital coverage by the firm. Instead, FI will notify the firm of the outcome of FI's supervisory capital assessment, as information addressed to the firm's CEO and board of directors. FI finds that this proceeding is in line with the legislator's intention, because according to the supervision act, FI is given the possibility of deciding on a specific own funds requirement, but may refrain from making such decisions if the breach is negligible or excusable or if the firm rectifies the matter. There are many more reasons as to why FI finds this method suitable.

First, the supervisory review and evaluation process, which includes the supervisory capital assessment, is a continuous process in which the risk profile is constantly updated. A formal decision is static and cannot be changed without taking a considerable amount of time.

Second, it is particularly important that FI has the possibility of giving due consideration to the specific situation and the current circumstances in which a firm in financial stress finds itself, at the time of a situation arising that would give FI reason to find it necessary to make a formal decision. If a firm is in severe financial stress, its risk profile can change in a short space of time. For example, certain risks included in the assessment of the Pillar 2 basic



requirement might have materialized, which might mean there are no longer grounds for requiring the firm to hold capital for them.

Third, it ought to be positive for financial stability that a firm has the possibility, using rapid and resolute measures, as agreed with FI, to restore its capital without the firm necessarily becoming subject to priorly specified and automatic legal restrictions. In other words, firms are hence given the possibility of re-establishing their capital in a strained situation without automatic restrictions on distributions or, depending on the size of the capital shortage, a formal resolution phase being activated. The Riksbank indicates that it will probably be more difficult to find appropriate ways to restore capital the lower the level of capital adequacy. This is correct, and it is therefore important to point out that the fact of restrictions on distributions not automatically applying by no means implies that firms will be able to delay strengthening their own funds. The purpose is instead to achieve more options in terms of the *way in which* own funds can be strengthened.

FI shares the Riksbank's opinion that market participants, and other stakeholders, must be able to obtain as complete a picture as possible of the firm's risk profile. However, FI finds that this can be achieved without formal decisions being made. FI intends to increase the transparency of Pillar 2 (see section 2.9). Furthermore, FI is of the opinion that, as firms disclose their capital adequacy ratios on a quarterly basis, market participants and other stakeholders will be able to demand accountability and explanations from both the firms and FI in the event of the capital strength of the firms considerably weakening without sufficient effort being made to restore the capital.<sup>21</sup> FI also wishes to point out that the law states that FI is obliged to make a decision if the firm's breach is not negligible or excusable, or if the firm does not rectify the matter. FI therefore does not share the Riksbank's fear of market confidence in the capital requirements potentially being undermined if formal decisions are not made in normal circumstances.

In summary, FI's position is considered to give both FI and the firms greater freedom of action to identify, in relation to the actual situation, appropriate ways of restoring the capital in ample time.

In terms of the scope of a Pillar 2 decision, FI finds that FI, within the framework of Chapter 6, section 1–2 of the BFBA, is obliged to assess a firm's risk level, comprising all risks to which the firm may become exposed and the risks which the firm poses to the financial system, in relation to the firm's total capital. If FI finds that the firm's total risk level is too high in relation to its total capital, the authority may make a Pillar 2 decision through which the own funds of the firm are determined, see Chapter 2, section 1 of the supervision act. If a firm has more than one risk (or risk element) not covered by Pillar 1,

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<sup>21</sup> The obligation of the firms to disclose information regarding their capital adequacy is regulated in Finansinspektionen's regulations (FFFS 2014:12) regarding prudential requirements and capital buffers



and must therefore be covered by Pillar 2, FI therefore does not have the legal ability to make a Pillar 2 decision for only one or a few such risks.

#### *2.8.5.2 Account of how the firm intends to restore the capital*

Also in a situation in which a firm has a capital shortage, FI can refrain from making a formal decision about a specific own funds requirement if the breach is negligible or if the firm rectifies the matter. In order for FI to be able to efficiently monitor to ensure that the firm rectifies the matter, i.e. that the firm intends to restore and consequently does restore its capital sufficiently quickly and resolutely, FI intends, in the framework of its supervision, to request a written account of how it intends to restore the capital. This provides FI with effective possibilities to review and assess the firm's plans.

### **2.8.6 Examples of FI's assessment of the need for a decision on specific own funds requirements**

#### *2.8.6.1 When a decision is not necessary*

As described above, FI's point of departure is that a formal decision on specific own funds requirements will only be taken if it is deemed necessary. In normal circumstances, FI's supervisory capital assessment will be provided as information, and not as a formal decision.

“Normal circumstances” refers in this respect to a firm having, in periods of normal or booming economic activity, own funds that cover the total minimum and buffer capital requirement (this refers to the minimum requirement under Pillar 1, the Pillar 2 basic requirement, all buffers described in the buffer act to the extent that it exceeds the capital conservation buffer). Furthermore, in order for it to be considered “normal circumstances”, the firm's capital policy must state that the firm has the objective of holding own funds that at least equal that level, insofar that it is not exposed to financial stress that exceeds the equivalent of a normal recession. See also section 2.5

#### *2.8.6.2 When a decision might become necessary*

Should a firm end up in a situation in which its own funds fall below the total minimum and buffer capital requirement (with account taken of the Pillar 2 basic requirement and the capital planning buffer) due to financial stress, FI will intensify its supervision activities with respect to the firm. This will involve FI, among other measures, requesting that the firm provides an account of how it intends to restore the capital. If the firm has a credible plan for restoring the capital, it is not necessary for FI to make a formal decision regarding a specific own funds requirement. Should, on the other hand, FI be of the opinion that the measures are insufficient, FI can judge it necessary to make a formal decision regarding a specific own funds requirement including the Pillar 2 basic requirement. A decision on a capital planning buffer will

however not normally be required if the firm is already in a situation of financial stress.

In this context, it should be pointed out that, in a situation of severe financial stress, the buffers may be drawn down – that being their purpose. Because of this, it should be noted however that the firms are not permitted to *plan for* drawing down anything other than the capital conservation buffer (see section 2.5). There is hence a difference between what it is reasonable to require firms to plan for, and the choices FI has to make if an event even more severe than what the firm planned for transpires.

As stated in the legal basis, neither the Pillar 2 basic requirement nor the capital planning buffer affect the automatic restrictions on distributions, as long as a formal decision on a specific own funds requirement has not been made. Hence, in such a situation, a firm may freely choose, in the framework of other applicable regulations and under FI's review, the most suitable way of restoring the capital in that specific situation. For example, the firm is not obliged to halt or limit dividends or interest payments on Tier 1 capital contributions, if the firm can identify other and more appropriate ways of restoring the capital sufficiently quickly. (This applies as long as there is no shortfall from the combined buffer requirement under the Pillar 1 rules, i.e. excluding the specific own funds requirement).

Should the firm, due to financial stress, find itself in a situation of an imminent risk of the buffers being fully drawn down, and of own funds potentially falling below the total minimum capital requirement (i.e. the minimum capital requirement under Pillar 1 and a not formally decided Pillar 2 basic requirement), it will be necessary for FI to formally decide on a specific own funds requirement. In this situation, FI will, in the decision on the level of the Pillar 2 basic requirement, give due consideration to the specific circumstances prevailing in the situation in which the firm finds itself. A decision taken when the firm is exposed to financial stress will not normally include the capital planning buffer, but only the Pillar 2 basic requirement.

#### 2.8.6.3 *When a decision is necessary*

Should the firm in its capital policy (or equivalent) state a capital objective that falls short of the total minimum and buffer capital requirement (that is, including the supervisory capital assessment in Pillar 2), FI will call the firm's attention thereto. Should the firm nevertheless not rectify the matter, i.e. choose to not adjust its capital objective to cover the total minimum and buffer capital requirement, or choose to not act to reach or maintain this capital objective, FI will make a decision on both the Pillar 2 basic requirement and the capital planning buffer. (In this case, FI is entitled to make a decision not only on the Pillar 2 basic requirement, but also on the capital planning buffer, because it would be a case of deficient compliance with Chapter 6, section 2 of BFBA and Chapter 8, section 4 of SMA. See section 2.5.) In terms of the capital planning buffer, however, only the part that exceeds the size of the

capital conservation buffer, i.e. which is in excess of 2.5 per cent of the risk-weighted exposure amount, will be covered by the decision on a specific own funds requirement.

It should be noted here that, should the firm, after a decision on a specific own funds requirement has been made, choose to hold a capital level that involves it failing to cover the capital conservation buffer, it shall, according to the buffer act, submit a capital conservation plan to FI. The plan must show how the firm, in a reasonable amount of time, is to reach the combined buffer requirement. Hence, a firm is not permitted to breach the requirement to maintain a capital conservation buffer other than for a shorter (reasonable) time.

### **2.8.7 Clarification on the agreement with other authorities**

Chapter 4, sections 4 and 5 of the supervision act expresses that FI shall agree with authorities from other countries included in the international supervisory college on a suitable level for the group's own funds with due consideration for the group's financial situation and risk profile, and the level of own funds required to apply Chapter 2, section 1 of the mentioned Act to both individual units and the group as a whole. The agreement referred to is binding for FI, as it is for the other authorities concerned. FI intends to apply it to firms in the way described above in the section on FI's decision-making.

In FI's opinion, the decision on the group's combined own funds made in the framework of the supervisory college is not binding for the firms in the group because it is not a formal decision made according to Chapter 2, section 1 of the supervision act. In other words, it is not a formal decision in the sense referred to in FI's position in section 2.8.3.

## **2.9 Transparency**

### **2.9.1 Introduction**

To date, the practice of FI and the firms concerned has been not to make FI's supervisory capital assessment of the individual firms public.<sup>22</sup> Because the capital requirements under Pillar 1 are clearly increased through the Capital Requirements Regulation and the Swedish implementation of the Capital Requirements Directive<sup>23</sup> coming into effect, the specific own funds requirements in Pillar 2 will constitute an even more important factor in devising the capital policy of firms than it has been so far. FI also finds that the intended effect of macroprudential measures within Pillar 2 are clarified and

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<sup>22</sup> In the case of FI's risk weight floor for Swedish mortgages (See Risk weight floor for Swedish mortgages, on fi.se, from 21 May 2013, FI Ref. 12-11920), FI chose, for that specific risk element, to publish the effect for the largest groups concerned.

<sup>23</sup> This relates primarily to the new buffer capital requirements and tightened definition of own funds.

potentially also strengthened through full transparency of their effects on the capital requirements of firms.

In light of this, FI will increase the transparency of Pillar 2 with a view to improving the market's understanding of the total capital strength of the firms.

### **2.9.2 Feedback received**

**The Swedish Bankers' Association** supports the approach chosen by FI in terms of transparency. They go on to express, however, that it is crucial that the requirements for banks in terms of publishing information regarding Pillar 2 is consistent with that approach inasmuch as the banks cannot be expected to publish Pillar 2 requirements until FI has completed its methodology development and FI itself finds it appropriate to publish such requirements. In previous regulatory proposals, FI has introduced requirements for banks to disclose their total capital need. The Bankers' Association finds that regulations regarding disclosure of the total capital need should be put on hold until FI has prepared the objective measures to which FI refers.

**The Swedish National Debt Office** welcomes FI's intention to increase transparency of specific own funds requirements, which can be considered to be of particular importance in light of the possibilities of the new regulations to take account of systemic risks within the framework of such requirements.

**Sveriges Riksbank** welcomes FI's proposal to publish in detail the parts of the Pillar 2 basic requirement that have macroprudential purposes, and also takes a positive view to FI's intention to create a standardised assessment process for the other types of risk included in the Pillar 2 basic requirement, and publish the methods for this assessment.

### **2.9.3 FI's planned measures**

In order to increase transparency of Pillar 2, FI will publish the capital effect of the parts that can be fully or partially said to have macroprudential purposes, such as the risk weight floor, in detail for all the large groups concerned.<sup>24</sup> The consequence analysis in section 7 of this memorandum describes the parts of the supervisory capital assessment referred to here, for each individual large group concerned. FI also intends to publish, on a quarterly basis, updated figures for the large groups, regarding these very components of the supervisory capital assessment.

The specific own funds requirement imposed by FI on the firms in the framework of Pillar 2 are made up of many different components that vary in character. Some components, such as those presently pertaining to systemic

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<sup>24</sup> FI already did this in when the current risk weight floor was introduced. See the consequence analysis in the memorandum Risk weight floor for Swedish mortgages. Published on 21 May 2013 on fi.se.

risk and the risk weight floor, are standardised using the exact same calculation method for all firms covered, while others encompass more individualised assessment methods.<sup>25</sup> FI has an ambition to standardise the assessment of further risk types included in the Pillar 2 basic requirement, and in connection therewith publish the methods of this assessment. Once a standardised approach for capital assessment has been made public, FI will also publish and, in relevant parts, quarterly update the outcome of the assessment at firm level.

The firms primarily affected by FI's analysis are the very largest groups, currently the firms covered by the detailed consequence analysis in section 7. For these, FI performs the supervisory capital assessment at least once a year.

By reason of the Bankers' Association's viewpoint regarding the obligation of firms to disclose information regarding Pillar 2, FI wishes to refer to the reasons set out on page 29 of the decision memorandum for Finansinspektionen's regulations (FFFS 2014:12) regarding prudential requirements and capital buffers.<sup>26</sup> FI writes the following therein: "Finansinspektionen wishes to point out that the questions regarding the disclosure of internally assessed capital requirements differ from the questions regarding disclosure brought up in the memorandum regarding capital requirements for Swedish banks. According to the regulations, a firm shall publish its own capital need assessment. The memorandum addresses the matter of disclosing Finansinspektionen's assessment of a firm's capital need."

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<sup>25</sup> FI's decision on a specific own funds requirement is firm-specific, which could be interpreted as FI not being able to provide a general conclusion on its risk assessment. However, it is the case that certain risks are common to all firms with a certain type of exposures.

<sup>26</sup> FI Ref. 11-13269 Published on fi.se on 8 July 2014.

### 3 Capital requirements for systemically important firms

#### 3.1 Background

##### 3.1.1 *International standards*

The Basel 3 agreement and the amended EU regulations aim both to strengthen the resilience of individual firms to firm-specific risks, and strengthen the resilience of the entire financial system to systemic risks. The new EU regulations introduce new instruments for better counteracting risks in the entire financial system, known as systemic risks.

The latest financial crisis brought to light the negative effects that global systemically important firms can have on the financial system and economy at large. During the crisis, many countries provided comprehensive government support to save systemically important firms with a view to upholding financial stability. They were, quite simply, considered too important to fail due to their size and, in certain cases, complex and cross-border operations.

The new EU regulations on buffer requirements for global systemically important firms is based on the G20 agreement from 2011 to impose demands on systemically important firms in terms of holding extra capital on top of the minimum requirement set out in the Basel 3 agreement.<sup>27</sup> The Basel Committee has developed a method for identifying and globally managing Global Systemically Important Banks, G-SIB.<sup>28</sup> Based on this method, the Basel Committee and Financial Stability Board regularly publish a list of global systemically important firms.

On the instruction of G20, the Basel Committee also prepared a framework, presented in the autumn of 2012, to identify Domestic Systemically Important Banks, D-SIB.<sup>29</sup>

Based on these international efforts, the EU has introduced requirements for Member States to introduce a buffer for global systemically important firms and has made it possible for Member States to introduce buffer requirements for other systemically important firms. Besides these two buffer requirements, the EU has also made it possible for Member States to introduce a systemic risk buffer.

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<sup>27</sup> FSB (2011), Policy Measures to Address Systemically Important Financial Institutions, [www.financialstabilityboard.org/publications/r\\_111104bb.pdf](http://www.financialstabilityboard.org/publications/r_111104bb.pdf)

<sup>28</sup> [www.bis.org/publ/bcbs255.htm](http://www.bis.org/publ/bcbs255.htm)

<sup>29</sup> [www.bis.org/publ/bcbs233.htm](http://www.bis.org/publ/bcbs233.htm)

### 3.1.2 *The November Accord*

In Sweden, as mentioned previously, FI, together with the Riksbank and the Ministry of Finance, in November 2011 described its expectations on the forthcoming capital need of Swedish systemically important firms (the November Accord). According to the agreement, the ambition was to impose on systemically important banks a capital surcharge for systemic risk of 3 per cent from 2013 and 5 per cent from 2015 on top of the own funds requirement specified in the proposals for the new the Capital Requirements Regulation and Capital Requirements Directive of that time.

In summary, it involved a combined requirement for a common equity Tier 1 capital ratio of 10 per cent from 1 January 2013 and 12 per cent from 1 January 2015.<sup>30</sup> According to the press release, the levels include a capital conservation buffer requirement and a capital surcharge for systemically important banks, but not requirements for a countercyclical capital buffer.

The agreement also expressed that the extra capital requirement for systemically important banks should primarily apply to the four major banks at consolidated level, i.e. Handelsbanken, Nordea, SEB and Swedbank.

The November Accord was entered before the Capital Requirements Directive and Capital Requirements Regulation were ready in their final form. Hence, the November Accord did not specify how the higher capital requirements were to be implemented based on the new EU regulations.

## 3.2 Description of the capital requirements for systemic risk

The Capital Requirements Directive introduces a number of different tools to prevent and counteract both structural and cyclical systemic risks. Member states are enabled to introduce both a systemic risk buffer and capital buffers for systemically important institutions. In addition, the competent authority shall evaluate the need for capital in order to manage systemic risks also in Pillar 2. See also section 5 on the countercyclical capital buffer.

Requirements for a *systemic risk buffer* may be introduced to prevent and reduce long-term structural systemic risks that can have serious negative effects on the financial system or real economy of a certain Member State. The requirement can be imposed on all firms concerned or on firms in certain parts of the financial sector. The systemic risk buffer may amount to 3 per cent in common equity Tier 1 capital on all risk-weighted exposures. As of 1 January 2015, requirements can be placed for a further 2 per cent in a systemic risk buffer on exposures within the country and in a third country.

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<sup>30</sup> The total capital ratio requirement is 3.5 percentage points higher and can be filled using other Tier 1 capital and, to a certain extent, Tier 2 capital.



As of 1 January 2016, two capital buffers for systemically important firms will be introduced; *the capital buffer for global systemically important institutions (G-SII)* and *the capital buffer for other systemically important institutions (O-SII)*. Their purpose is to limit the risk posed by systemically important firms to the financial system. The buffer requirement for global systemically important institutions is compulsory, unlike the buffer requirement for other systemically important firms.

The buffer requirement for global systemically important firms is only imposed at consolidated level and may amount to a maximum of 3.5 per cent in common equity Tier 1 capital on all risk-weighted assets. The buffer requirement for other systemically important institutions can be imposed both at firm and consolidated level, and can be set at no more than 2 per cent.

Firms which, at consolidated level, are subject to requirements for both a global systemically important institution buffer and a buffer for other systemically important institutions need not fulfil both, but only the higher of the buffer requirements. That buffer is called the applicable buffer for systemically important institutions. Requirements for an applicable buffer for systemically important institutions is not additional to any requirements placed on a systemic risk buffer. The higher of the systemic risk buffer and the applicable buffer for systemically important institutions is the one that applies. If requirements for a buffer for systemically important institutions are only placed on the risk-weighted exposure amount in the country or in a third country, the systemic risk buffer is added together, however, with the applicable buffer for systemically important institutions.

In section 2, the supervisory capital assessment is described. FI can also, in the framework thereof, when deciding on a specific own funds requirement, also take account of systemic risks to which FI finds the firm exposes the financial system.

### **3.3 The systemic risk buffer**

#### **3.3.1 Position**

FI intends to decide that the four major banks, as of 1 January 2015, shall hold a systemic risk buffer of 3 per cent in common equity Tier 1 capital. The requirement applies to total risk-weighted assets at consolidated level.
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#### **3.3.2 Feedback received**

**The Swedish Bankers' Association** would like to see a discussion of what could bring about a change in the requirement. Article 133(10) of the Capital Requirements Directive sets out that the systemic risk buffer shall be reviewed at least every other year.



**Sveriges Riksbank's** fundamental opinion is that it would be desirable to implement the increased capital requirements for systemically important banks in their entirety within Pillar 1. However, the Riksbank expresses that, in light of the limited possibilities afforded by EU law for Sweden to implement the capital adequacy requirements of the November Accord within Pillar 1, it must be deemed reasonable that systemic risk surcharges in excess of 3 per cent be imposed on institutions in the form of a specific Pillar 2 basic requirement.

**The Swedish National Debt Office** expresses that, even though the technique FI chooses to implement the capital surcharge is of no consequence to the total capital requirements of major Swedish banks, it is reasonable that it be done primarily through the buffers intended for that purpose. The capital surcharges that will now be made using the systemic risk buffer should therefore, as of 2016, be replaced by the appropriate buffer for systemically important institutions (and, if needed, be supplemented using the systemic risk buffer or Pillar 2 requirements). Furthermore, the National Debt Office writes that, in terms of the level of capital surcharge, it is not motivated in any way other than it being in line with the agreement reached between the authorities in November 2011. Here, the National Debt Office would like to have seen a more thorough analysis of what constitutes an appropriate capital surcharge level.

**The Confederation of Swedish Enterprise** shares FI's view that the size of the Swedish banking system poses a risk to financial stability, and that in light of this, the systemic risk buffers are justified.

**The Financial Sector Union of Sweden** opposes FI's proposed increases to capital requirements. The Union finds that FI's motives do not suffice. The Union would like to see the banks competing on equal terms, both in Sweden and internationally. No proposals are aimed at limiting the profitability targets of banks. The consequence will thus be many more notices of redundancy that make reference to the increased capital requirements.

### **3.3.3 Legal basis**

The provisions of the Capital Requirements Directive on the systemic risk buffer are implemented in Swedish law through Chapter 4 of the buffer act. According to Chapter 4, section 1, FI may, with the purpose of counteracting a structural systemic risk that could entail serious consequences for the stability of the financial system and real economy in Sweden, decide that firms, for all or some of their exposures at individual level, subgroup level and consolidated level, shall have a systemic risk buffer.

According to Chapter 4, sections 3 and 4 of the buffer act, FI may decide on a systemic risk buffer amounting to a maximum of 3 per cent of the firm's total risk-weighted exposure amount. Exemptions from the 3 per cent limitation may be granted. This requires the approval of the EU Commission, however. In Chapter 4, section 6, it is stated that FI may decide that firms shall have a

systemic risk buffer amounting to more than 3 per cent of the total exposure amount if FI has fulfilled the notification requirement of Article 133.12 of the Capital Requirements Directive, and that such a measure has been approved by the EU Commission, in accordance with Article 133.15 of the same Directive. Article 133.12 of the Capital Requirements Directive expresses that the Commission shall approve the higher amount with due consideration for ESRB's and EBA's assessment and if it is convinced that the higher buffer does not entail disproportionate adverse effects on the whole or parts of the financial system of other Member States or of the Union as a whole, forming or creating an obstacle to the functioning of the internal market. The systemic risk buffer may, without the approval of the EU Commission, amount to a further 2 percentage points, i.e. a maximum of 5 per cent, of the institution's risk-weighted exposure amount based solely on the institution's exposures in Sweden or outside of the EEA.

Furthermore, Chapter 10, section 1, point 2 of the buffer act states that the Government or the authority designated by the Government may issue regulations on the policies that are to be observed when establishing and grading the systemic risk buffer according to Chapter 4, section 1 of the same law. The Government has, in the framework of the authorisation, decided on provisions regarding capital buffers in the prudential requirements and capital buffers ordinance.

### **3.3.4 Reasons for FI's position**

Today, Sweden has four predominant banking groups – Handelsbanken, Nordea, SEB and Swedbank (known as the major banks). If any of the four major Swedish banks were to default, this would currently be hard to manage without major risks to the economy. There is a lack of sufficiently effective authority tools for warding off a situation of one of the major banks risking default, without Swedish taxpayers being exposed to risks and without risking disruptions in the functions performed by the major banks that are value-creating and crucial to society. The default of one major bank could also directly have tremendous effects on the other major banks.

The capital adequacy of banks is intended to bear (absorb) unexpected losses. FI therefore finds that the four major banks need to have greater loss-bearing capacity in the form of common equity Tier 1 capital of a further 5 percentage points at consolidated level to cover systemic risk. This means that FI's current assessment is the same as the one that formed the basis for the November Accord. This requirement for common equity Tier 1 capital of 5 percentage points entails, as a comparison, the major banks, in addition to the other requirements of the capital rules, securing further resilience equalling a drop in value of their total assets of approximately 1 per cent.

The systemic risk buffer could provide scope to fully reach the extra common equity Tier 1 capital of 5 percentage points that FI current considers necessary and sufficient for systemic risk related reasons. However, a decision regarding

a systemic risk buffer in excess of 3 per cent requires the approval of the EU Commission, as described in the legal basis in section 3.3.2. Because FI may take account of systemic risk in Pillar 2 (see section 3.4), FI finds it appropriate not to decide on a systemic risk buffer in excess of the level within FI’s own decision-making power. Addressing systemic risks in Pillar 2 instead is therefore more appropriate and brings an efficient decision-making process.

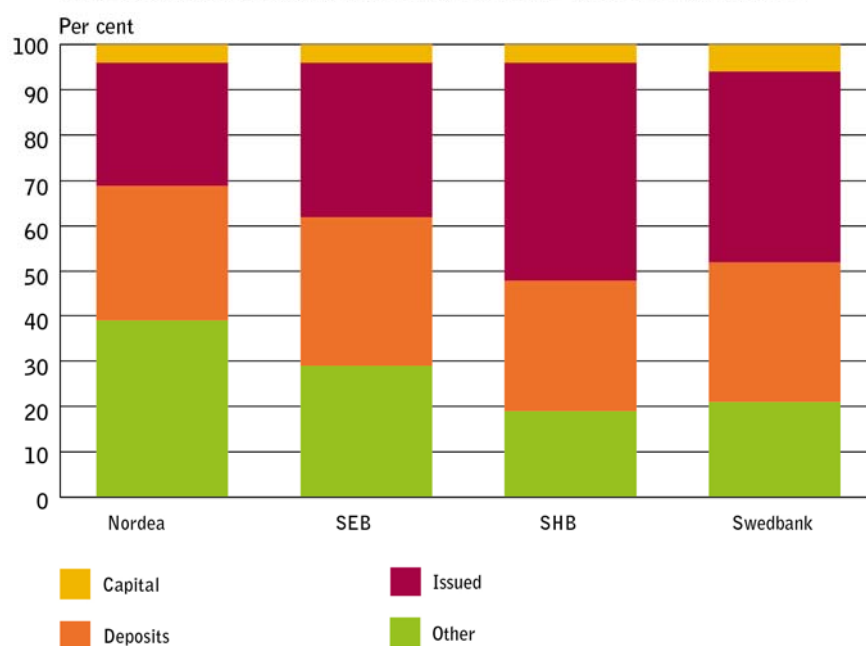
The financial system, and ultimately the economy too, is exposed to structural risks due to the most systemically important Swedish banks operating on a concentrated market, with similar exposures, and being closely interlinked. In the event of uncertainty surrounding the resilience of the banking system, demands from the funding market tend to increase and access to liquidity and funding is made more difficult and expensive for the banks. This occurred, for example, in the autumn of 2008, showing how financial problems for any of the most systemically important banks risk spreading to the rest of the financial system, and ultimately risk sharply weakening the economy.

The four major Swedish banks largely have *similar business models*, which can lead to problems for the financial system being amplified in a crisis. The banks partially have the same type of structure in terms of both assets and funding. The types of assets, and exposure at geographic level, exposure classes and counterparties are largely of the same nature and sometimes overlap. The funding structure is also largely similar, in terms of e.g. a structural deposit deficit, a large share of covered bonds and extensive borrowings in foreign currency.

**3.1 Distribution of lending (Data at Q4 2013 at consolidated level)**



### 3.2 Distribution of funding (Data at Q4 2013 at consolidated level)

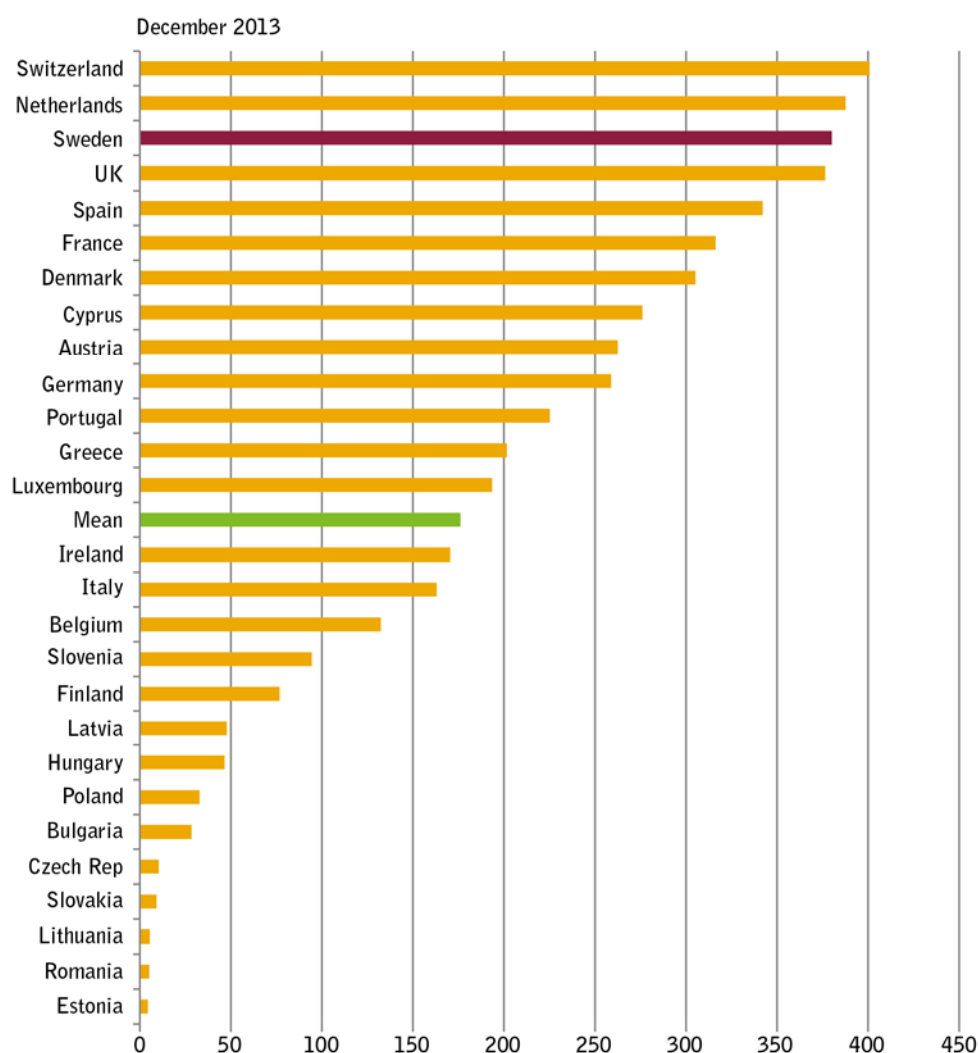


The domestic markets of the major Swedish banks are highly *concentrated*. This is particularly the case in Sweden, where the four major Swedish banks overall have a completely dominant market share in most business segments. A high degree of concentration is an indicator that the losses of an individual bank risk increasing at the same time as problems arise for the financial system as a whole.

The similarities in terms of business model and structure, combined with the high degree of market concentration, have also led to a clear *interlinkage* between the four major Swedish banks. The banks are interlinked through direct exposures to each other, and indirectly, in that a bank's actions can affect both the value of assets of and funding terms for the other banks. The interlinkage can thus have negative consequences in times of crisis that risk being amplified by market uncertainty or deficient information giving rise to reputational risks.

The interlinkage between the four major Swedish banks constitutes a source of systemic risk, particularly in combination with the *size* of the banking system in relation to the Swedish economy. Major shocks in the financial system thus risk leading to serious and negative consequences for the real economy. The importance of the major banks also makes it difficult in Sweden to deflect or soften a crisis for a major, cross-border systemically important bank without major costs for society.

### 3.3 The banks' assets in relation to GDP



Note: The data for Switzerland is from December 2012

Source: The Riksbank

Structural factors in the Swedish financial system thus indicate that disruptions in one of the four major banks risk being amplified and having a major negative impact on the economy. The risk of a financial crisis is thus not necessarily greater in Sweden, but there is a risk that the consequences of a banking crisis – if it were to occur – would be major.

In the event of a financial systemic crisis, weakened market confidence in the Swedish banks also risks damaging confidence in the creditworthiness of the Swedish Government. There is a risk of more expensive borrowing costs for the Government. This hence risks coinciding with a situation of funding on decent terms probably being of great importance to enable flexibility for managing the effects of a crisis on the real economy. The structure of the Swedish banking market thus leads to high costs for society if the stability of the banks is called into question, and mutually positive effects for both the Government and the financial system if the banks have a high level of resilience to shocks and financial crises.

A reason as to why credit firms generally fund themselves with equity to such a low extent is that such firms benefit from a number of implicit and explicit government guarantees. This makes depositors and other creditors less sensitive to the firm's risks, which in turn reduces borrowing costs and hence gives shareholders an incentive for wanting as high a degree of loan financing as possible. This is particularly evident for the firms considered to be systemically important and which, in a crisis, are therefore expected to be rescued by the government through different types of support measures. This gives systemically important credit firms a competitive advantage. In FI's opinion, a targeted increase in capital requirements for such firms does not pose a competitive disadvantage; rather the increase can rather imply that competition with other credit firms is somewhat evened out.

The general capital requirements of the Capital Requirements Regulation do not cover the risk posed by the structural vulnerability of the Swedish banking system. This risk could lead to major costs for society in the event of a financial crisis. The basis in the Capital Requirements Directive for establishing the scope of the need for buffer capital for systemic risk, is that each Member State is obliged to protect the banking system and the real economy from systemic risks that can arise due to structural factors or specific exposures. However, determining a necessary or sufficient size for the systemic risk buffer will, by necessity, largely be a qualitative assessment.

As described above, the Swedish banking system has certain structural features that distinguish it from the European banking system as a whole. FI finds that the Swedish financial system, and ultimately the real economy, is exposed to greater risks than the basic level required by the Capital Requirements Regulation. Such higher structural risks arise due to the high systemic importance of Nordea, SEB, Handelsbanken and Swedbank. In order to increase resilience to shocks, these banks thus need a high level of loss-bearing capacity. FI therefore finds that the four major banks should hold a systemic risk buffer of 3 per cent.

### ***3.3.5 Decision-making procedure for the systemic risk buffer***

According to Chapter 4, section 1 of the buffer act, FI may decide that a firm shall have a systemic risk buffer. FI intends, at its Board meeting on 8 December 2014, to make a decision directed at the four major banks stating that, as of 1 January 2015, they shall establish a systemic risk buffer of 3 per cent at consolidated level.

FI therefore intends to review the systemic risk buffer in accordance with the provisions of the Capital Requirements Directive. As indicated by the Swedish Bankers' Association, Article 133(10) of the Capital Requirements Directive sets out that the buffer shall be reviewed at least once every other year.

### 3.4 Specific own funds requirement for systemic risk under Pillar 2

#### 3.4.1 Position

The four major banks shall, in addition to the systemic risk buffer of 3 per cent, be subject to a capital surcharge of 2 per cent for systemic risk in the framework of the Pillar 2 basic requirement. The requirement will be imposed on total risk-weighted assets at consolidated level and be covered by common equity Tier 1 capital.

#### 3.4.2 Feedback received

**The Swedish Bankers' Association** expresses that there lacks a description of how often FI intends to evaluate the measures taken within Pillar 2, with particular reference to the capital surcharge of 2 per cent for systemic risk. The Bankers' Association finds that it would be reasonable for FI, at least once a year, to publicly communicate its opinion on the need for each measure. Furthermore, the Bankers' Association writes that, in light of the importance and complexity of the matter, there is a need for a discussion between the banks and FI regarding how measures taken within the Pillar 2 process are affected by various factors, and may change.

#### 3.4.3 Legal basis

FI may, according to Chapter 2, section 1 of the supervision act, decide that a firm shall have a specific own funds requirement in excess of the minimum level that otherwise applies (that is, on top of what is required by the Capital Requirements Regulation and the buffer act). Decisions on such a specific own funds requirement can be made if FI, in connection with a review and evaluation, finds that it is needed to cover the risks to which the firm exposes the financial system (systemic risks). Read more on the specific own funds requirement in section 2.

Furthermore, Chapter 10, section 2 point 4 of the supervision act states that the Government or the authority designated by the Government may issue regulations regarding the circumstances that are to be observed when establishing an appropriate own funds level in connection with a review and evaluation of a firm. By reason thereof, it follows that section 9 of the prudential requirements and capital buffers ordinance, that FI, in its supervision, shall follow the provisions regarding the supervisory review and evaluation process in Articles 97–101 of the Capital Requirements Directive. The provisions of the Directive set out that the competent authorities shall evaluate the risk that a firm poses to the financial system. Furthermore, it is set out in the bill for the supervision act and buffer act, prop. 2013/14:228, that FI, within the framework of decisions on specific own funds requirements following a review and evaluation, also ought to be able to give due



consideration to the risk to which the institution exposes the financial system (systemic risks), see section 11.3.1

#### **3.4.4 *Reasons for FI's position***

In the opinion of FI, as stated in section 3.3.3, the need for a higher loss-bearing capacity in the Swedish financial system is matched by a total capital surcharge of 5 percentage points for the four most systemically important bank groups. Three percentage points of the capital need are made up of the systemic risk buffer. The remaining 2 percentage points shall therefore be covered by a surcharge for systemic risks within the Pillar 2 basic requirement. The reasons for why FI is choosing to cover part of the capital need for systemic risk in Pillar 2 were provided in section 3.3.3.

The purpose of the systemic risk surcharge in Pillar 2 is, as for the systemic risk buffer, to secure greater loss-bearing capacity for the firms that pose the greatest systemic risk, in order, in so doing, to bolster the resilience of the financial system and reduce the risk of shocks being amplified and affecting the real economy.

FI hence bases the application of the systemic risk surcharge in Pillar 2 on the same drivers of risk and indicators as for the systemic risk buffer. Because it is an overall determination of the scope of the capital need for systemic risk, the result of the risk assessment will be the same also if it is based on the risk in individual firms and groups, which shall be the basis for an assessment within Pillar 2.

#### **3.4.5 *Implementation***

The introduction of capital requirements for systemic risk under Pillar 2 is a change in practice and not a new regulation. This implies that a formal date of entry into force will not be required. Rather, the change in practice is implemented in connection with publishing this memorandum immediately in FI's concerned processes.

FI's supervisory review and evaluation process, which includes the supervisory capital assessment, is performed at least once a year for the major banks. Hence FI shall, at least once a year, state and motivate the specific own funds requirement, broken down into Pillar 2 basic requirements and the capital planning buffer, which such banks need to hold. In this manner, the banks are regularly given an updated, individual assessment of their total capital need. Furthermore, FI continually monitors the effect of the authority's taken measures at systemic level, which is primarily communicated through FI's stability report, which is published twice a year. Besides this, FI currently has no plans to, as often as annually, as desired by the Swedish Bankers' Association, formally evaluate and review the size of the systemic risk surcharge in Pillar 2. FI wishes to point out that the assessment of the systemic

risk posed by the four major banks and the extra capital need entailed by the risk are based on an assessment of sluggish structural risks.

### **3.5 Buffer for global systemically important institutions**

The provisions of the Capital Requirements Directive on a buffer for global systemically important institutions are implemented in Swedish law through Chapter 5 of the buffer act. According to Chapter 5, section 1, FI may decide which firms are to have a capital buffer for global systemically important institutions. The buffer shall, according Chapter 5, section 2 of the same Act, consist of common equity Tier 1 capital and amount to no less than 1 per cent and no more than 3.5 per cent of the firm's total risk-weighted exposure amount.

The provisions regarding the buffer for global systemically important institutions shall, according to section 2 of the law (2014:967) implementing the Capital Buffers Act, be applied as of 1 January 2016. According to section 4 of the same law, the buffer requirements for global systemically important institutions shall be phased in during 2016–2019.

EBA will, in accordance with Article 131.18 of the Capital Requirements Directive, prepare a technical standard for supervision specifying the method for identifying global systemically important firms, and the buffer requirements that are to apply. There will, however, be a certain degree of scope for national considerations.

FI has not yet taken a position on how the buffer for global systemically important institutions is to be implemented. FI will decide on which firms are to have a capital buffer for global systemically important institutions, and the scope of this buffer before the regulations come into effect.

### **3.6 Buffer for other systemically important institutions**

The provisions of the Capital Requirements Directive on a buffer for other systemically important institutions are implemented through Chapter 5 of the buffer act. According to Chapter 5, section 3, FI may decide that a firm is to have a capital buffer for other systemically important institutions. The buffer shall, according Chapter 5, section 4 consist of common equity Tier 1 capital and amount to no more than 2 per cent of the firm's total risk-weighted assets.

The provisions regarding the buffer for other systemically important institutions will, according to section 2 of the law (2014:967) implementing the buffer act, come into effect on 1 January 2016. In Chapter 10, section 1, point 5 of the buffer act, the Government or the authority designated by the Government is authorised to issue regulations on how other credit institutions are to be identified and how the assessment of the relevant capital buffer requirement is to be made.

The Capital Requirements Directive sets out a number of criteria that the competent authority shall take into account when assessing other systemically important firms. EBA will also prepare guidelines further specifying how the competent authority is to identify such firms.<sup>31</sup>

FI has not yet taken a position on how the buffer for other systemically important institutions is to be implemented. FI will decide on which firms are to have a capital buffer for other systemically important institutions, and the scope of this buffer before the regulations come into effect.

### **3.7 Summary of capital requirements for systemically important firms**

On the whole, the positions described in this section involve the four major banks holding, from 1 January 2015, a total of 5 percentage points in common equity Tier 1 capital at consolidated level for counteracting systemic risk that could entail serious consequences for the stability of the financial system and the real economy in Sweden.

This is implemented such that FI intends to decide that the four major banks shall hold a systemic risk buffer of 3 percentage points as of 1 January 2015. The four major banks shall also hold 2 percentage points in common equity Tier 1 capital for covering systemic risk in the Pillar 2 basic requirement from 1 January 2015. Both of these requirements will be imposed on all risk-weighted assets at consolidated level.

FI will revert with which firms shall have a buffer for global systemically important institutions and other systemically important institutions, and how large these buffers are to be, before the legal provisions regarding these buffers start to apply on 1 January 2016. In these decisions, FI will take account of forthcoming technical standards and guidelines from EBA. As stated in section 3.2, the capital buffers for global systemically important institutions and other systemically important institutions are not additional to the systemic risk buffer. (That is, they are not incremental to the systemic risk buffer.) Hence, the total capital requirement for the major banks will not be affected by the buffers for global systemically important institutions and other systemically important institutions, because they are covered by the systemic risk buffer. The total capital requirement for other firms may be affected by the buffer for other systemically important institutions.

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<sup>31</sup> See EBA's consultation document *Consultation on guidelines on criteria to assess other systemically important institutions (O-SIIs)*, published on [eba.europa.eu](http://eba.europa.eu) on 18 July 2014.

## 4 Increase to the risk weight floor for Swedish mortgages

### 4.1 Introduction

This section provides FI's opinion and position as regards the level of the risk weight floor for Swedish mortgages. Swedish mortgages amount on the whole to an amount equalling much more than half of Sweden's GDP. FI is therefore of the opinion that it is crucial to financial stability that firms hold own funds that cover the risks in such lending. Responsibility for financial stability supervision not only includes analysing imbalances among financial institutions and non-financial corporations and households, but also taking measures.<sup>32</sup>

The present risk weight floor was introduced on 21 May 2013 and the level was then set at 15 per cent. In November last year, FI presented new measures that might be required to reduce risks in household indebtedness.<sup>33</sup> The assessment made by FI at the time was that raising the risk weight floor to 25 per cent would be a sound decision. That memorandum also specified that a key element in that measure is that FI is empowered by legislation to take into consideration the systemic risks to which individual firms give rise in mortgage lending, when the authority assesses an appropriate level for the risk weight floor. The laws that implement the new capital adequacy regulations (see more in section 1) have now been decided by Swedish Parliament.

### 4.2 Background

#### 4.2.1 *Current risk weights for Swedish mortgages*

In order to determine the capital requirement for credit risk, the exposure amount for each credit exposure is multiplied by a risk weight. This results in a risk-weighted amount, and it is this amount that is subject to capital requirements.

When the Basel 2 agreement entered into force in Sweden in 2007 through amendments to the Capital Requirements Directive (often called CRD 2), several Swedish firms received permission from FI to use the internal ratings-based approach (IRB approach) to calculate the risk weights for their credit exposures. As a result, the risk weights for Swedish mortgages fell drastically. All predominant mortgage lenders in Sweden currently use the IRB approach, and several of the largest players have average risk weights in the internal models of around 5 per cent for such exposures. In May 2013, FI introduced a

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<sup>32</sup> See section 1 of Finansinspektionen's Instructions Ordinance (2009:93).

<sup>33</sup> How FI can decrease the risks inherent in household debt. Published on fi.se on 14 November 2013, FI ref. 13-12811.

risk weight floor for Swedish mortgages of 15 per cent in the framework of Pillar 2.

The risk weights of 5 per cent and 15 per cent, respectively, can be compared to 50 per cent in Basel 1, i.e. the regulations that applied until 2007 and which still form the basis of the Basel 1 floor<sup>34</sup>, and 35 per cent in the currently applicable standardised approach.<sup>35</sup>

#### 4.2.2 *About the IRB approach*

The IRB approach consists of two parts:

- The risk weight formula – which is set out in the Capital Requirements Regulation and serves as the basis for the calculation of the capital requirement.
- Expected loss – which is determined by the banks in accordance with the minimum requirements of the Capital Requirements Regulation, and constitutes input data for the risk weight formula.

The expected loss is set per exposure. An individual risk weight is subsequently calculated for each individual exposure in the portfolio. The estimation of the expected loss is based on historical credit loss data. The calculation method is regulated by the Capital Requirements Regulation.

The low risk weights ensuing from the IRB approach reflect the very low credit losses for Swedish mortgages in the past 20–25 years. Swedish firms meet the minimum requirements for using the IRB approach for Swedish mortgages and carry out the calculations in accordance with the requirements set out in the regulatory framework and established industry practice.

#### EXPECTED LOSS

Expected loss is a simplified umbrella term for the estimates made by banks within the IRB approach. Banks in fact estimate three risk parameters for exposures to mortgages.

<sup>34</sup> See Finansinspektionen's approach to the Basel 1 floor. Memorandum published on 18 March 2014 on fi.se, FI Ref. 13-13990.

<sup>35</sup> In order to properly compare the approaches, the expected loss amount, less reserves and other value adjustments, must be added to the capital requirement in the IRB approach. However, for most firms, this amount is currently a small part of the total capital requirement for the Swedish mortgages. In this context, it should also be noted that, unlike in Basel 2, lending collateralised by tenant-owned apartments does not count as lending collateralised by residential property in Basel 1, and therefore were risk-weighted at 100 per cent.

- **PD**, Probability of Default
- **LGD**, Loss Given Default
- **Exposure amount**, also called EAD, Exposure At Default

Default in this context means roughly that the credit counterparty is really late with payment or that the lender makes an assessment that it is probable that the counterparty will not be able to pay on time.

The Expected Loss (EL) is calculated using the three risk parameters multiplied by each other.

#### **4.2.3 About FI's present risk weight floor**

On 21 May 2013, FI published the introduction of a risk weight floor for Swedish mortgages in the context of the supervisory capital assessment under Pillar 2. The floor was set at 15 per cent for the portfolio's average risk weight. The reason for the present risk weight floor is that FI finds that the IRB approaches of firms do not sufficiently capture the credit loss risk in Swedish mortgages. The conclusion that risk weights for Swedish mortgages are to be at least 15 per cent is the result of an overall assessment of future loss levels in Swedish mortgages in a situation of intense financial stress.

When the present risk weight floor was introduced, "the old" capital adequacy regulations were still in effect in Sweden; that is, the Capital Adequacy and Large Exposures Act (2006:1371). When implemented, FI was aware of the forthcoming regulations. The risk weight floor was thus devised both with its legal basis in the old regulations in place at the time, and on the assumptions that could be made at the time about how the future regulations would be devised and implemented. In the former Swedish legislation, the legal basis for an extra own funds requirement for systemic risk was not expressed as it is in the supervision act.

### **4.3 FI's position**

The risk weight floor is increased by 10 percentage points, from 15 per cent currently to 25 per cent.

When calculating the capital requirement in which the risk weight floor results, all capital requirements under Pillar 1 must be included, including the countercyclical buffer rate for Sweden. In addition, for the major banks, the full capital need for systemic risk shall be taken into account.<sup>36</sup>

<sup>36</sup> Hence, besides the systemic risk buffer of 3 per cent, the capital requirement for systemic risk of 2 per cent imposed on the major banks within the framework of Pillar 2 (see section 3) must also be taken into consideration in the calculation of the capital requirement for Swedish mortgages.

#### 4.4 Feedback received

**The Swedish Bankers' Association** finds the increase to the risk weight floor unwarranted. The systemic risk argument presented by FI is based on household indebtedness having risen to unsustainably high levels, and that this is driven by constantly rising house prices. The Bankers' Association expresses that a higher risk weight floor for mortgages will only affect the supply and price of mortgages to a limited extent. Considering the effectiveness of the risk weight floor in this respect, it is therefore inappropriate to use it as a measure to reduce the growth rate of household lending.

According to the Bankers' Association, calculation of the risk weight floor should be based on the minimum capital requirement with an increment for the capital conservation buffer and the systemic risk buffer in Pillar 1. In the opinion of the Bankers' Association, FI, through the proposal to include the systemic risk buffer in Pillar 2 in the calculation of the capital requirement for the risk weight floor, is distancing itself from the methodology communicated previously, which leads to confusing and double-counting of different Pillar 2 requirements.

The Bankers' Association expresses that there lacks a description of how often FI intends to evaluate the measures taken within Pillar 2, with particular reference to the risk weight floor. The Bankers' Association finds that it would be reasonable for FI, at least once a year, to publicly communicate its opinion on the need for each measure. Furthermore, the Bankers' Association writes that, in light of the importance and complexity of the matter, there is a need for a discussion between the banks and FI regarding how measures taken within the Pillar 2 process are affected by various factors, and may change.

**Swedbank** expresses several arguments against increasing the risk weight floor. First, the bank finds that housing construction is far too low, which has contributed to increased property prices and the growing debts of households. Measures that curb the possibilities of households to mortgage homes can therefore only temporarily stop the price increases, and are not sustainable solutions in the long term. An increased risk weight floor for mortgages will impede the banks' mortgage lending to private customers, and could hence contribute to a temporarily slower price increase for homes. However, it does not solve the fundamental structural problem of too few homes being built, and that the population of major cities is outgrowing housing. Second, the bank finds that an increase to loan costs in terms of cash flows can be introduced in different ways, and that the different alternatives have different consequences as regards income distribution. An increase to the risk weight floor enriches the banks' shareholders, while scaling back tax relief on paid interest provides the government with more revenues, and an amortisation requirement implies mortgaged households having to pay more money to themselves in a form of compulsory saving. Third, the bank expresses that the increased risk weight floor will entail that the capital requirements on mortgages in the banks'



balance sheets will be high in relation to the actual risk of loss. This, in turn, will give rise to incentives to securitise, or transfer in another way, mortgages to investors not covered by the risk weight floor. The Swedish originate-and-hold model has historically contributed to low risks for mortgages. A transfer to a model in which the banks systematically transfer mortgages to other parties might have major negative consequences for the Swedish mortgage market in the long term. Fourth, Swedbank points out that the increase to the risk weight floor creates an erroneous allocation of capital between and within the banks. The main risk for Swedish banks in a combination of declining house prices and a poorer economy is not credit losses in the mortgage portfolio, but credit losses arising in other portfolios due to ailing demand. A risk weight floor on mortgages is therefore highly misplaced if the ambition is to protect banks from the shock to the system that declining house prices would create. Fifth, the bank expresses that the risk weight floor overturns the system of sound, risk-differentiated risk weights. The advantages of the system mentioned by the bank are transparency, that it creates a common gauge and that it is necessary for maintaining well-balanced governance of a bank's risk-taking and business operations. The more risk weights are established on grounds other than risk by the regulator, the more difficult it will be to discern real risks, and the more difficult it will be to put an accurate price on credits from a risk perspective. Finally, the bank expresses that capital requirements for banks that are too high risk leading to an under-supply of capital for other parts of industry, because there will be less capital available for other sectors.

Furthermore, Swedbank objects to the view of the countercyclical capital buffer being included in the calculation of the capital requirement in which the risk weight floor results. The bank finds it illogical for this to form part of the calculation. The purpose of the increased risk weight floor seems to be to manage a mortgage-specific and cyclical risk. It is thus not reasonable to add on a further cyclical buffer requirement in the calculation of the risk weight floor. The method results in double-counting, which is neither acceptable nor desirable.

**Sveriges Riksbank** shares FI's opinion that it is currently wise to increase the risk weight floor for mortgages to 25 per cent. The Riksbank also supports FI's proposal to introduce increased risk weight floors as a Pillar 2 measure. Because the purpose of the increased risk weight floor is to strengthen the resilience of firms in the long term, it appears a more appropriate approach than taking time-limited measures supported by Article 458 of the Capital Requirements Regulation.

**The Swedish National Debt Office** finds that an increase to the risk weight floor is justified by the same reasons described by FI. However, the Debt Office wishes to emphasise that this increase should primarily be seen as a measure to strengthen the resilience of banks to the risks created by mortgage lending, and not necessarily as a measure to reduce the risks as such.

**The Confederation of Swedish Enterprise** supports the proposal for an increased risk weight floor. Because credit growth is mainly found among households, it is appropriate to manage these risks through an increased risk weight floor on mortgages. This also implies that the countercyclical capital buffer can be kept at a lower level, and that corporate lending is hence affected to a lesser extent than it would otherwise be.

**The Financial Sector Union of Sweden** opposes FI's proposed increase to the risk weight floor. In the opinion of the Union, FI's motives do not suffice, and are superficially described in the consequence analysis. The Union would like to see the banks competing on equal terms, both in Sweden and internationally. The Financial Sector Union of Sweden finds that no proposals are aimed at limiting the profitability targets of banks. The consequence will thus be many more notices of redundancy that make reference to the increased capital requirements.

**The Swedish National Board of Housing, Building and Planning** supports the increase to the risk weight floor. However, it wishes to add to the description of risks on the housing market. The National Board writes that potential future housing market reforms could lead to the financial system being exposed to systematic risks when the reforms lead to a decline in demand pressure and/or an increase in supply. It also points out that the risks entailed by mortgages are not limited to pure changes in consumption; rather, it is fairly certain that there is a risk of a potential drop in prices having a self-amplifying effect. The Swedish National Board of Housing, Building and Planning points out that there is every reason to take a very serious view of the systematic imbalances in the Swedish housing market, and the potential risks this brings to the financial system and real economy.

## 4.5 Legal basis

### 4.5.1 *Systemic risk in Pillar 2*

Detailed rules governing how firms are to calculate their risk-weighted exposure amounts for household exposures are provided in Part three, Title 2, Chapter 3, sections 2–5 of the Capital Requirements Regulation (articles 151–191).

Because the Capital Requirements Regulation is exactly that (i.e. a regulation), individual countries cannot introduce requirements that conflict with what it prescribes. FI can therefore not set higher requirements for the calculation of the risk-weighted exposure amount than what is expressed in the Capital Requirements Regulation. However, FI may, with the support of Chapter 2, section 1 of the of supervision act, decide that a firm shall have higher own funds than the minimum level that would otherwise apply if, within the framework of a review and evaluation, it is deemed necessary to cover risks to which a firm is or could become exposed, and risks to which the firm exposes

the financial system. Read more about the specific own funds requirement and FI's supervisory capital assessment in section 2.

According to section 11.3.1 of the bill for the supervision act and buffer act, prop. 2013.14:228, the provision requires neither a breach having occurred (i.e. that the firm has insufficient own funds) nor an assessment having been made of there being a risk of such a breach arising. The provision could thus be applied in the case of a firm using an approved IRB approach to calculate risk-weighted exposure amounts, but the method nevertheless entails an underestimation of the risks and hence of the capital need.

Furthermore, Chapter 10, section 2 point 4 of the supervision act states that the Government or the authority designated by the Government may issue regulations regarding the circumstances that are to be observed when establishing an appropriate own funds level in connection with a review and evaluation of a firm. By reason thereof, it follows that section 9 of the prudential requirements and capital buffers ordinance, that FI, in its supervision, shall follow the provisions regarding the supervisory review and evaluation process in Articles 97–101 of the Capital Requirements Directive. The provisions of the Directive set out that the competent authorities shall evaluate the risk that a firm poses to the financial system. Furthermore, the proposal expresses that FI, within the framework of a decision on specific own funds requirements following a supervisory review and evaluation, also ought to be able to give due consideration to the risk to which the institution exposes the financial system (systemic risks), see section 11.3.1.

FI's decision on a specific own funds requirement is firm-specific, which could mean FI not being able to provide a general conclusion on its risk assessment. However, the risk currently not taken sufficiently into account by the internal models of firms is common to all firms with the type of exposure in question here. Because the risk weight floor for Swedish mortgages is also an important matter in the capital planning of firms, FI finds it appropriate to specify the general assessment practice that the authority intends to apply in this regard.

## **4.5.2 *Alternative tools***

### **4.5.2.1 *Introduction***

As expressed above, it is not possible for FI to set higher requirements for the calculation of risk-weighted exposure amounts than those expressed by the Capital Requirements Regulation to ensure that firms hold more capital in relation to their Swedish mortgages. The new capital adequacy regulations also contain, however, other provisions that enable adjusting risk weights for mortgages.

#### 4.5.2.2 Possibilities of national flexibility

Article 458 of the Capital Requirements Regulation enables national authorities to e.g. increase risk weights for mortgages and commercial properties in certain circumstances. The possibility has been devised to cope with changes in the intensity of macroprudential risks or systemic risks, and introduces a number of tools, or measures, which Member States would have the possibility of using to this very end.

The provision specifies that the measures described in the article may be taken in *temporary* periods of heightened risk for a *limited time period* of no more than two years, with the possibility of extension. Also, the competent authority must explain, to the European Parliament, the European Commission, the European Council, the ESRB and the EBA why the identified macroprudential risk or systemic risk cannot equally be addressed in the framework of Pillar 2. Furthermore, the Council, on the proposal of the Commission, is entitled to refute such measures.

The overarching purpose of FI's new practice is to strengthen the firms' resilience *in the long term* against such shocks that Article 458 is intended to address for a limited time. The inability of the competent authority to achieve the same result through measures in Pillar 2 is, as mentioned, also a condition for a measure in the framework of the article.

#### 4.5.2.3 LGD floor

Article 164 of the Capital Requirements Regulation specifies how Loss Given Default (LGD) is to be calculated. The fourth point of the article describes that the average LGD value for all retail exposures secured by residential properties without government guarantees may not be below 10 per cent. This floor rule has been applied since the introduction of internal models for credit risk.

A new feature in the Capital Requirements Regulation is that the competent authority shall, according to the aforementioned article, annually perform an assessment of whether the minimum values for LGD in point 4 are appropriate for exposures secured by residential properties or commercial properties in their territory, and if it is suitable, in the interests of financial stability, to set higher minimum values than those pursuant to point 4.

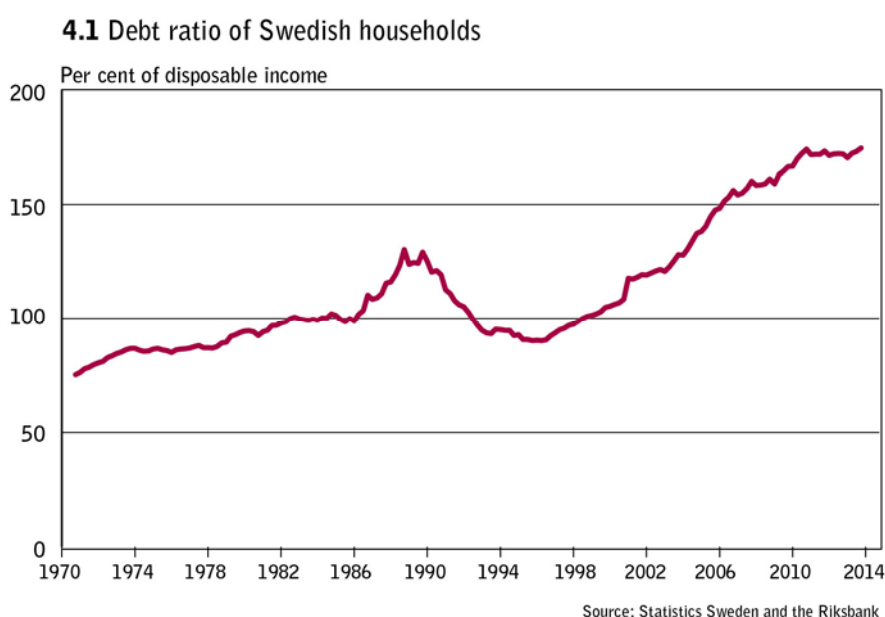
The LGD value has a direct linear relationship with the capital requirement for individual credits and hence also for the credit portfolio as a whole. Should, for reasons of stability, FI choose to increase the minimum level for LGD from 10 per cent to e.g. 30 per cent, this would mean firms which currently have average risk weights for mortgages of 5 per cent having risk weights of 15 per cent; that is, an increase of 10 percentage points. A firm with an average risk weight of 10 per cent would have a new average risk weight of 30 per cent, i.e. an increase of 20 percentage points. FI believes it would be unfortunate to further amplify the differences in risk weights which derive from the firms'

variations in internal approaches for calculating risk-weighted exposure amounts, but which are often fundamentally not motivated by a difference in the actual risk of the exposures. In light of this, the possibility in article 164 is less suitable for use compared with the possibility of addressing the matter in the supervisory capital assessment.

## 4.6 Reasons for FI's position

### 4.6.1 Description of the systemic risk caused by Swedish mortgages

Swedish household debt is at a historically high level, and is on the rise. The debt ratio (total household debt in relation to disposable income) has increased from 100 per cent to over 170 per cent in the last 15 years.



Mortgages make up the majority of household debt. This high level of household indebtedness through mortgages poses a risk to financial stability. High indebtedness, combined with a large share of variable-rate loans, makes household sensitive to changes in interest rates. Also, the biggest asset of many households is their home. If house prices fall, households are expected to be more restrained in their consumption, which could aggravate a recession. Furthermore, the mortgages of households make up a large proportion of the banks' total assets and involve a major funding need for the Swedish banking system.

The high indebtedness of households makes them vulnerable, both in terms of changes in interest rates and the trend on the housing market. Higher interest rates give rise to a higher housing cost for households, and lower consumption. Mortgage rates are at historically low levels and, if interest rates approach the historical average, a large part of the budget of households will need to go on interest expenses.

Higher interest rates can also change the calculation that forms the basis for purchasing homes, and affect the house price trend. House prices, mortgaging and interest rates affect each other.

A recession involves high financial and social costs for society. The high indebtedness of households can affect the real economy by aggravating a recession if mortgaged households cut down their consumption sharply. The most serious scenario in this context is a recession that coincides with a sharp drop in house prices.

There is reason to emphasise that, because the purpose of the capital adequacy regulations is to cover losses also during highly severe financial stress, it is not meaningful in this context for FI to take a position on how probable a sharp drop in house prices is. Even if a sharp drop in house prices were considered improbable, firms must hold capital covering the risks in such a scenario.

The reason why house prices might affect household consumption is that almost half of the collective assets of Swedish households consist of single-family dwellings, tenant-owned apartments and holiday homes.<sup>37</sup> This is a lot, but the aggregate measures are affected by a small number of households having major financial assets. If the very wealthy households are taken out of the statistics, single-family dwellings, tenant-owned apartments and holiday homes have an even higher share of the other households' assets. For a large part of the population, financial assets are limited, and the home is their absolute largest asset.

Household consumption does not just depend on current disposable income. When households decide how much they are to save and consume, they also consider how much their assets are worth. "Assets" should have a wide interpretation and do not just include the value of financial assets, but also properties and future income from employment.

When house prices decline sharply, households see that the value of their own home is lower than before. People who feel poorer find they cannot spend as much. Demand in the economy declines when households tighten their purses.

There are studies that suggest that mortgaged households reduce their consumption more than other households.<sup>38</sup> In such studies, the most highly mortgaged households cut back on spending the most when house prices decline.

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<sup>37</sup> Sveriges Riksbank. Financial Stability 2013:2.

<sup>38</sup> Andersen, A.L., Duus, C. and Jensen, T.L. (2014), "Household debt and consumption during the financial crisis: Evidence from Danish micro data", Danmarks Nationalbank Working Papers 89 and Dynan, K. (2012), "Is a Household Debt Overhang Holding Back Consumption?", Brookings Papers on Economic Activity.

There are more possible reasons for greater tightening among mortgaged households. One reason might be that some of the mortgaged households finance consumption with loans collateralised by their home. When the home is worth less, they might borrow and consume less. Another reason could be that households want to have a buffer between the value of the home and the mortgage. When the value of the home declines, the buffer shrinks. In order to restore the buffer, households have to save.

In Sweden, just over 60 per cent of households live in a single-family dwelling or a tenant-owned apartment, and the vast majority of them have mortgages. A sharp drop in house prices thus affects the majority of the population. A drop in house prices in a recession can lead households to further reduce consumption from already suppressed levels. Heavily mortgaged households might be expected to exercise even more restraint than more lightly mortgaged households. The high indebtedness of Swedish households through mortgages thus poses a risk to the real economy in Sweden.

Changes to the risk weight floor are not aimed at managing fundamental structural imbalances on the Swedish housing market, and cannot do so either.<sup>39</sup> The purpose is to ensure that firms hold capital for the systemic risks caused by mortgages so that the banking system is prepared for such risks from a capital adequacy perspective. Any other effects of the floor, such as demand for mortgages, can in certain respects be considered positive, but do not constitute reasons for the measure. In the evaluation of the measures directed at the demand side, the risk weight floor shall thus not be considered a direct alternative, even if its effects must be evaluated in an overall assessment of whether the measures that limit demand are necessary and appropriate.

#### ***4.6.2 Systemic risk, the IRB approach and the present risk weight floor***

##### *4.6.2.1 About the IRB approach and systemic risks*

Despite its name, only certain parts of the internal ratings-based (IRB) approach are an internal approach. The calculation of the capital requirement and the use of the approach are governed by detailed regulations. Swedish firms currently using the IRB approach for Swedish mortgages comply with the minimum requirements for the approach. The firms estimate the expected loss themselves (see fact box in section 4.2.2) based on historical credit loss data, and this is converted into a capital requirement using the risk weight formula specified in the regulations. According to this approach, the capital requirement should correspond to the credit loss in the mortgage portfolio arising during highly severe financial stress.

As expressed in section 4.6.1, Swedish mortgages can cause other costs than credit losses alone. As described, the purpose of the IRB approach is hence to

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<sup>39</sup> FI's view of the imbalances on the Swedish housing market have been developed in the report *Stability in the financial system* from June 2014, FI Ref. 14-999.



capture and reflect such costs that do not affect the firm directly in the form of credit losses in the mortgage portfolio. These so-called systemic risks are therefore not covered by the capital need calculated using the IRB approach.

#### *4.6.2.2 Present risk weight floor and systemic risks*

The present risk weight floor of 15 per cent was introduced because FI was of the opinion that the IRB approaches of firms do not sufficiently capture the credit risk in Swedish mortgages. In the memorandum published on 21 May 2013, it is expressed that FI finds that the IRB approach does allow for fully capturing changes in fundamental economic and contractual factors<sup>40</sup> that have an effect on the risk of credit losses.

The position in the memorandum from 21 May 2013, that the risk weight for Swedish mortgages is to be at least 15 per cent, is the result of an overall assessment of future loss levels in Swedish mortgages in a situation of intense financial stress. The floor level of 15 per cent thus does not cover systemic risks, but only the credit risk in mortgages.

#### *4.6.2.3 Overall assessment*

Swedish mortgages cause systemic risks. This risk is not covered either by the capital requirement calculated using the IRB approach or the present risk weight floor of 15 per cent, because both of these calculations only cover credit risk. The systemic risk caused by Swedish mortgages is thus currently not addressed in the existing capital requirements.

### **4.6.3 Assessment of the systemic risk level in Swedish mortgages**

FI must assess the scope of the systemic risk caused by Swedish mortgages in order to be able to include the risk in the capital requirement. While this is a difficult task, according to FI that does not constitute an adequate reason for addressing the risk in the capital requirement.

In FI's opinion, it is not appropriate to assess the scope of the systemic risk using a quantitative model. There is currently no generally accepted model. Instead, FI chooses to perform an overall assessment of what a reasonable level is.

Because it is clear that Swedish mortgages cause systemic risk, FI finds that the capital set aside to cover the systemic risk should constitute a clear increase to the present capital requirement for the portfolio, which is determined by the risk weight floor of 15 per cent. According to FI, this indicates that the floor should be increased by over 5 percentage points, i.e. to over 20 per cent.

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<sup>40</sup> "Contractual factors" refers to the terms and conditions agreed regarding the mortgage with respect to e.g. how the interest rate is to be calculated and the amortisation rate.

When it introduced the present risk weight floor, FI was of the opinion that credit risks in Swedish mortgages equal an average risk weight of at least 15 per cent. There is no objective criterion which, in itself, means the systemic risk in Swedish mortgages could not exceed the credit risk they contain. However, FI finds it reasonable that the capital that firms are obliged to hold for mortgages should to the most part reflect the risk of credit losses in the portfolio in question. This suggests that the present risk weight floor should be increased by less than its present level of 15 per cent, hence to a level that is lower than 30 per cent, with the purpose of covering the systemic risk.

A risk weight floor of 25 per cent, i.e. an increase of 10 percentage points, meets both the above criteria. FI thus finds this to be an appropriate level. This increase equals, in capital requirements, around 1 per cent of the exposure amount of the portfolio.

#### ***4.6.4 Cyclical and structural systemic risk in Swedish mortgages***

Section 3.3.3 states that FI finds that the four major banks need to have greater loss-bearing capacity in the form of common equity Tier 1 capital of a further 5 percentage points at consolidated level to cover systemic risk. This should also be reflected in the calculation of the Pillar 2 basic requirement in which the risk weight floor results. In the calculation of this capital requirement, FI will therefore take into consideration both the systemic risk buffer of 3 per cent and the further capital requirement of a further 2 per cent for systemic risk (described in section 3), which is imposed on the four major banks under Pillar 2.

The assessment that the risk weight floor will be increased to 25 per cent is based on the presence of long-term (albeit not necessarily permanent) so-called structural systemic risks. Because Swedish mortgages constitute such a large part of overall lending, mortgages also make a substantial contribution to aggregate credit growth, which is an important factor in assessing cyclical systemic risk. FI therefore finds it appropriate, in the calculation of the Pillar 2 basic requirement in which the risk weight floor results, to take into consideration the countercyclical buffer rate for Sweden.

The extra capital requirement for systemic risk of 5 percentage points for the major Swedish banks and the countercyclical capital buffer requirement are devised so as to stand in relation to the firm's risk-weighted exposure amount. FI finds that the risk posed by mortgages is more fairly reflected in the risk-weighted exposure amount if the risk weight floor is included. There is thus not deemed to be any double-counting of capital requirements by reason of account being taken of these capital requirements when calculating the capital requirement in which the risk weight floor results.

## 4.7 Description of the calculation method

### 4.7.1.1 Introduction

This section contains a detailed description of the calculation method which FI will use in the supervisory capital assessment for the specific assessment of whether a firm is holding sufficient capital to cover the risks in its Swedish mortgage exposures.

### 4.7.1.2 Scope

The firms covered by the measure are the Swedish firms authorised to use an internal model to calculate the capital requirement for credit risk (the IRB approach), and which have an exposure to Swedish mortgages. This currently applies to seven groups, and the firms included therein: Handelsbanken, Landshypotek, Länsförsäkringar Bank, Nordea, SBAB, SEB and Swedbank. Six savings banks are also subject to the floor: Bergslagens, Färs & Frosta, Rekarne, Sjuhärad, Vimmerby and Ölands.<sup>41</sup>

If a further firm were given authorisation to use the IRB approach to calculate the capital requirement for Swedish mortgages, this firm too would be covered by the measure. Firms using the standardised approach to calculate the capital requirement for credit risk are not affected.

Branches of foreign firms that are exposed to Swedish mortgages and which use the IRB approach for them might also be affected. The conditions for this are described in section 4.8.

### 4.7.1.3 Definition of affected portfolio

The portfolio covered by the risk weight floor, and which in this memorandum is, in simplified terms, referred to as “Swedish mortgages”, consists of Swedish exposures collateralised by immovable property in the exposure class household exposures. The exposure class by far largely consists of mortgages for private individuals, but can also include certain exposures to small corporations with loans collateralised by real estate and exposures that are loans collateralised by real estate other than residential properties. For an exact definition, see Articles 147.5 and 154.3 of the Capital Requirements Regulation.

It is largely the same definition that applied when the present risk weight floor was introduced. The difference is that the exposure class now, since the entry into force of the Capital Requirements Regulation, is no longer defined in FI’s regulations, but in the Capital Requirements Regulation. This also involves

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<sup>41</sup> All of them are included in the Swedbank group, except Bergslagens Sparbank since Swedbank sold its holding of shares to the Savings Bank Foundation in 2010. However, they nevertheless have permission to use an internal model as individual firms.

some slight differences in relation to the previous definition in FI's regulations. However, the differences are not of such magnitude as to lead FI to review the level of the present risk weight floor. Hence, no part of the increase to the floor is due to amendments to the definition.

#### *4.7.1.4 Definition of average risk weight*

The risk weight floor relates to the exposure-weighted average risk weight. The exposure-weighted average risk weight is calculated by dividing the portfolio's risk-weighted exposure amount by the exposure amount.

#### *4.7.1.5 Capital requirement and capital type*

In order to calculate the capital need in SEK for Swedish mortgages, taking the risk weight floor into account, the exposure amount of the portfolio is first multiplied by 25 per cent (the risk weight floor). This amount is then multiplied by the applicable capital requirement.

The capital requirement is 10.5 per cent, including the capital conservation buffer. For the major banks, 5 percentage points are also added, in accordance with the positions in section 3. (See also section 4.5.4) When the capital buffers for global and other systemically important institutions have been decided, these will also be included in the calculation.

As expressed in section 4.5.4, not only structural but also cyclical systemic risks should be covered by the supervisory capital assessment with respect to Swedish mortgages. This means that the level of the countercyclical buffer rate in Sweden will also affect the Pillar 2 basic requirement for mortgages. Note that this marks a difference compared to what was previously specified with respect to the present risk weight floor.<sup>42</sup>

Hence, on the whole, the risk weight floor for the major banks is calculated using a total capital requirement of 15.5 per cent, plus the countercyclical buffer rate. For other firms, the risk weight floor is calculated using a capital requirement of 10.5 per cent plus the countercyclical buffer rate.

The type of capital that is to cover the specific own funds requirement for Swedish mortgages is the same allocation of capital as the Pillar 1 capital requirement, including all buffer requirements. In addition, consideration must be given to the 2 percentage points for systemic risk imposed on the four major banks (described in section 3).

The specific own funds requirement constitutes part of the Pillar 2 basic requirement and not the capital planning buffer, read more in section 2.

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<sup>42</sup> See the memorandum Risk weight floor for Swedish mortgages, published on fi.se on 21 May 2013. Fi Ref. 12-11920.

### Calculation examples

Calculation example A, specific own funds requirement for Swedish mortgages:

Group A, which is *not* one of the four major banks, has an exposure amount of SEK 100 billion for Swedish mortgages. The current average risk weight according to the IRB approach is 5 per cent. For this group, the risk weight floor of 25 per cent involves a specific own funds requirement for Swedish mortgages of SEK 2.3 billion, of which SEK 1.6 billion consists of common equity Tier 1 capital, according to the calculation below.

Increase in the average risk weight (floor reduced by the current average risk weight):

$$25\% - 5\% = 20\%$$

Increase in the risk-weighted assets (increase in the average risk weight multiplied by the exposure amount):

$$20\% * SEK\ 100\ billion = SEK\ 20\ billion$$

Specific own funds requirement (increase in risk-weighted assets multiplied by the own funds requirement which, including the capital conservation buffer and a countercyclical capital buffer for Sweden of 1 per cent<sup>43</sup>, is 11.5 per cent):

$$SEK\ 20\ billion * 11.5\ \% = SEK\ 2.3\ billion$$

Specific own funds requirement covered by common equity Tier 1 capital (increase in risk-weighted assets multiplied by the common equity Tier 1 capital requirement, which, including the capital conservation buffer and a countercyclical capital buffer for Sweden of 1 per cent, is 8 per cent):

$$SEK\ 20\ billion * 8\ \% = SEK\ 1.6\ billion$$

Calculation example B, specific own funds requirement for Swedish mortgages:

Group B, which *is* one of the four major banks, has an exposure amount of SEK 500 billion for Swedish mortgages. The current average risk weight according to the IRB approach is 10 per cent. For this group, the risk weight floor of 25 per cent involves a specific own funds requirement for Swedish mortgages of SEK 12.4 billion, of which SEK 9.8 billion consists of common equity Tier 1 capital, according to the calculation below.

<sup>43</sup> See FI's decision memorandum for the regulation regarding the countercyclical buffer rate, FI ref. 14-7010.

Increase in the average risk weight (floor reduced by the current average risk weight):

$$25\% - 10\% = 15\%$$

Increase in the risk-weighted assets (increase in the average risk weight multiplied by the exposure amount):

$$15\% * SEK 500 \text{ billion} = SEK 75 \text{ billion}$$

Specific own funds requirement (increase in risk-weighted assets multiplied by the own funds requirement which, including the capital conservation buffer, a total surcharge of 5 per cent for systemic risk, and a countercyclical capital buffer for Sweden of 1 per cent, is 16.5 per cent):

$$SEK 75 \text{ billion} * 16.5\% = SEK 12.4 \text{ billion}$$

Specific own funds requirement covered by common equity Tier 1 capital (increase in risk-weighted assets multiplied by the own funds requirement which, including the capital conservation buffer, a total surcharge of 5 per cent for systemic risk, and a countercyclical capital buffer for Sweden of 1 per cent, is 13 per cent):

$$SEK 75 \text{ billion} * 13\% = SEK 9.8 \text{ billion}$$

#### 4.7.1.6 *Expected loss*

The capital requirement, expressed in relation to the risk-weighted assets, aims to cover unexpected losses, expressed simply as the losses which exceed the expected loss (see also the fact box on page 46) and which arise in a certain level of financial stress. The expected loss, which should more or less equal the long-term average loss, is normally covered in an average year by the firm's accounting provisions. The IRB rules specify that there is an additional deduction from own funds in cases where the total expected loss amount, calculated using the IRB approach, exceeds the firm's provisions and other value adjustments according to its accounting. Because provisions in an average year in general can be expected to correspond to the expected loss, the deduction is currently small in relation to the capital requirement for mortgages for most of the firms affected.

The effect of the expected loss amount on capital adequacy is not covered by the risk weight floor. Its impact on own funds will thus continue to be calculated going forward in the same way as it is today.

#### 4.7.2 *Implementation*

The increase to the risk weight floor is a change in practice and not a new regulation. This implies that a formal date of entry into force will not be required. Rather, the change in practice is implemented in connection with publishing this memorandum immediately in FI's concerned processes.

FI's supervisory review and evaluation process, which includes the supervisory capital assessment, is currently performed at least once a year for the largest firms. Hence FI then states and motivates the specific own funds requirement, broken down into Pillar 2 basic requirements and the capital planning buffer, which such firms need to hold. In this manner, the firms are regularly given an updated, individual assessment of their total capital need. Furthermore, FI continually monitors the effect of the authority's taken measures at systemic level, which is primarily communicated through FI's stability report, which is published twice a year. Besides this, FI currently has no plans to annually formally evaluate and review the size of the risk weight floor. In this context, FI wishes to point out that the assessment of the level of the risk weight floor is based on an assessment of sluggish structural risks.

#### **4.8 The application of the risk weight floor for foreign branches**

Section 2 describes the legal basis for a specific own funds requirement in Pillar 2. FI has decision-making powers relating to the specific own funds requirement for the firms and groups at consolidated level that are domiciled in Sweden, but not relating to foreign branches in Sweden. Nevertheless, despite the lack of formal decision-making powers, FI has the ability to influence the supervisory capital assessment relating to the substantial operations of foreign branches in Sweden through its participation in what are known as supervisory colleges. This occurs through FI taking part in the joint risk assessment of the group, which takes place in the framework of the supervisory college and which forms the basis of the supervisory capital assessment.

Danske Bank's branch is currently the only foreign branch that uses the IRB approach and which conducts substantial operations on the Swedish mortgage market. FI is a member of the supervisory college for Danske Bank, which is headed by the Danish supervisory authority. FI has requested the Danish supervisory authority to take into consideration the systemic risks caused by Swedish mortgages in its supervisory capital assessment of Danske Bank.



## **5 The countercyclical capital buffer**

### **5.1 Introduction**

According to the buffer act, FI is the authority which is to set the countercyclical buffer rate in Sweden and decide on reciprocity for the buffer rates of other countries.

FI's position regarding to the choice of method for setting the countercyclical capital buffer rate in Sweden is covered in the decision memorandum for the regulation regarding the countercyclical buffer rate (FI ref. 14-7010). Responses to all viewpoints received on the matter are hence included there. That decision memorandum also includes the background and other explanations for the countercyclical capital buffer.

The positions pertaining to FI's view of reciprocity for the countercyclical capital buffer and setting of the buffer rate for third-country exposures are however addressed in this section.

### **5.2 Reciprocity and setting a countercyclical buffer rate for a third country**

#### **5.2.1 Introduction**

The competent authority of each country sets the countercyclical buffer rate that is to apply for that country. Thus it must be specified how the Swedish firms with exposures outside of Sweden are to apply these buffer rates.

#### **5.2.2 Position**

FI will, as of the time of the Swedish law coming into force, recognise the countercyclical buffer rate decided by a competent authority of another EEA country up to 2.5 per cent.

For countercyclical buffer rates above 2.5 per cent decided by the competent authority of another EEA country, FI will decide on the application in each individual case as the need arises.

FI will not set a countercyclical buffer rate for non-EEA countries besides the buffer rate established by the country, given the current economic conditions. This position will be regularly reviewed.

### 5.2.3 *Feedback received*

**Sveriges Riksbank** supports the approach of FI, as early as from the entry into force of the buffer act, recognising the countercyclical buffer rate decided by the competent authority of another EEA country. In terms of the possibility of setting a countercyclical buffer rate for non-EEA countries that is higher than the rate set by the country, the Riksbank would like to point out that FI should reserve the possibility of setting higher rates if so deemed appropriate in individual cases.

### 5.2.4 *Legal basis*

The provisions on reciprocity of the Capital Requirements Directive regarding countercyclical buffer rates are implemented in Swedish law through Chapters 6 and 7 of the buffer act and section 5 of the law implementing the buffer act (2014:967).

FI may, according to section 5 of the law implementing the buffer act (2014:967), recognise until 31 December 2018 the shorter transitional periods of other Member States for the countercyclical capital buffer in accordance with Article 160.6 of the Capital Requirements Directive. When taking decisions to recognise the countercyclical buffer rates of other Member States, FI shall meet the notification obligation specified in the aforementioned Article of the Capital Requirements Directive. According to the notification obligation, FI shall inform the parties concerned of its recognition, including the EU Commission, ESRB, EBA and relevant supervisory colleges.

As of 31 December 2018, when calculating the firm-specific countercyclical capital buffer for exposures in other EEA countries, the countercyclical buffer rate decided by the competent authority of that country will always be applied, although no more than 2.5 per cent (see Chapter 6, section 5 of the buffer act). If the firm-specific countercyclical capital buffer is to be calculated based on a countercyclical buffer rate determined by a foreign competent authority within the EEA, the buffer rates shall be applied as of the date set by the foreign authority (Chapter 6, section 6 of the same law). If a foreign authority within the EEA has set a countercyclical buffer rate exceeding 2.5 per cent of the total risk-weighted exposure amount, FI may, according to Chapter 7, section 4 of buffer act decide that Swedish firms shall, for relevant credit exposures in that country, apply a buffer rate exceeding 2.5 per cent of the total risk-weighted exposure amount. However, it cannot be a question of the latter until after 31 December 2018.

FI may, according to Chapter 7, section 5 of buffer act, also set the countercyclical buffer rate that the domestic firms are to apply for exposures to a third country, i.e. non-EEA countries, in calculating the firm-specific countercyclical capital buffer. This possibility presupposes either that there is no buffer rate for the third country to which one or several firms in Sweden have exposures, or if a set countercyclical buffer rate in a third country is

insufficient to protect the firms in Sweden from risks associated with excessive credit growth in the third country. FI may then apply a higher but not a lower buffer level than that set by the third-country authority for the domestic firms' calculation of the firm-specific buffer rates. If the set buffer rate of the foreign authority exceeds 2.5 per cent, there is no obstacle to setting a rate below that level. However, the level may not be below 2.5 per cent. Hence, if FI has not approved the higher countercyclical buffer rate of a third country, firms shall, to their exposures in the third country, apply a countercyclical buffer rate of 2.5 per cent. If, on the other hand, FI has chosen to set a higher buffer rate for the third country than the buffer rate that already applies, as FI is so entitled, FI shall also set a date from which the domestically authorised firms are to apply the higher buffer rate in calculating the firm-specific countercyclical capital buffer. The date may not be later than 12 months following the decision. If the date is less than 12 months following the decision, this shall be motivated on specific grounds (see Chapter 7, section 6 of the buffer act).

According to an authorisation in Article 138 of the Capital Requirements Directive, ESRB may issue recommendations regarding the suitable countercyclical buffer rate for exposures in a third country.

### ***5.2.5 Reasons for the position***

FI generally takes a positive view to Swedish firms operating in other countries applying the same countercyclical buffer rates as the foreign firms. This is of importance so that firms in different countries can compete on equal terms. It is also important in preventing firms from circumventing the measures of authorities by transferring operations to other countries, which could lead to the measures not having the intended effect. FI is also understanding of the fact that other countries see a need to set a shorter transitional period for the countercyclical capital buffer than that which applies as the lowest rate of introduction according to the Capital Requirements Directive.

FI's generally positive attitude to Swedish firms having to apply the same countercyclical buffer rates as the foreign firms applies irrespective of the buffer requirement level. When setting a buffer rate above 2.5 per cent, FI finds, however, that there may be specific circumstances that need to be analysed. FI therefore reserves the right to determine, in each individual case, whether buffer rates above 2.5 per cent shall be applied.

## 6 Risk weights for Norwegian mortgages

### 6.1 Introduction

By reason of a request from the Norwegian supervisory authority, Finanstilsynet, FI describes in this section its view of risk weights for Norwegian mortgages. Finanstilsynet wishes, for Swedish firms operating on the Norwegian mortgage market, that FI applies the tightened requirements for risk weights for Norwegian mortgages that Finanstilsynet has introduced for Norwegian firms.

### 6.2 Background

In a letter to FI dated 16 January 2014<sup>44</sup> Finanstilsynet described for the first time the authority's plans to tighten requirements for firms' calculations of risk weights for Norwegian mortgages in the framework of the IRB approach. In the letter, Finanstilsynet stated that the tightened requirements should also be applied to Swedish firms operating on the Norwegian mortgage market, and requested FI's comments on this. FI responded on 11 March 2014 that the authority took a positive view to tightening requirements for the Swedish firms in the framework of Pillar 2.

On 1 July 2014, Finanstilsynet published the tightened requirements in their final form. In connection therewith, Finanstilsynet requested once more that FI comment on the view that the tightened requirements should also be applied to Swedish firms operating on the Norwegian mortgage market. FI then confirmed in a letter that the authority's previous position applied, both for the firms with subsidiaries in Norway and those which conduct operations through branches, i.e. that the tightened requirements will be applied to the Swedish firms in the framework of Pillar 2.

### 6.3 Feedback received

**The Swedish Bankers' Association** expresses that there are strong reasons for assessing whether risks covered in a certain way in one Member State are already covered by domestic national requirements or are covered in another way (e.g. in the framework of the banks' internal capital assessment) before the measures of another Member State are recognised.

**Sveriges Riksbank** has no objections to this part.

**The Swedish National Board of Housing, Building and Planning** supports that risk weights for Norwegian mortgages be adapted to the tightened requirements from Finanstilsynet in Norway.

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<sup>44</sup> The letter was published on [finansstilsynet.no](http://finansstilsynet.no) on 9 April 2014.

#### 6.4 FI's implementation of Finanstilsynet's request

In the letter to Finanstilsynet, FI stated the following. In order to take Finanstilsynet's requirement for increased risk weights for Norwegian mortgages into consideration, FI is adding a supplement in Pillar 2 at consolidated level. The supplement equals the difference between the actual average risk weight according to the IRB approach, and an average risk weight of 25 per cent. The proposed supplement might be adjusted if the firms concerned show that the effect of Finanstilsynet's tightened rules equal a higher or lower supplement.

Finanstilsynet has stated that the effect of the tightened rules implies that the affected banks' average risk weight for Norwegian mortgages will vary between 20 and 25 per cent. As a basis, FI has therefore chosen to add a supplement at consolidated level for the affected Swedish firms that corresponds to an average risk weight of 25 per cent. Should the firms affected show that application of the tightened Norwegian rules involves a different level, the final level can be adjusted thereto. However, FI's ambition is, like the risk weight floor for Swedish mortgages, to apply the same average risk weight for all affected firms.

The Swedish firms currently affected by the tightened rules are mainly Nordea and Handelsbanken. Formally, SEB is also affected, but its exposures to Norwegian mortgages are very limited indeed.

FI shares the opinion of the Bankers' Association that if capital supplements are added to recognise the requirements of other countries, an assessment must first be made as to whether this supplement could involve the risk being covered twice. FI has made that very assessment in terms of Norwegian mortgages, and come to the conclusion that there is no double-counting. FI also wishes to clarify that it is excellent if the firms themselves take account of the risk in Norwegian mortgages in their internal capital adequacy assessment processes. However, this being done is not a reason for FI not taking it into account in FI's supervisory capital assessment; on the contrary, FI's supervisory capital assessment shall include at least the risks covered by the firms' internal capital adequacy assessment process.

## 7 Consequence analysis

### 7.1 Introduction

The purpose of FI's positions set out in this memorandum is to reduce the probability of financial crises, increase freedom to act for individual firms and for the entire financial system in the event of shocks, and to reduce costs for tax payers when a financial crisis strikes. Because, from a computational point of view, capital is a more expensive funding source than other funding, heightened capital requirements can lead to higher costs for the banks. Ultimately, many factors influence the extent to which higher capital levels lead to an increase in the banks' total funding cost in the long term, and by how much costs increase for the banks' customers in that process. In the assessment of the economic effects, consideration must also be given to the benefits to society from e.g. a reduced probability of financial crises, and the major costs for society they entail.

The following section describes the effects to which FI's proposed application of the new capital adequacy rules are expected to lead for individual firms, on competition and the market, households and non-financial corporations and on the economy.

On the whole, FI finds that the forthcoming regulations bring about increased economic benefit because the costs are considered limited and the advantages of having stable banks are great. At the same time, there is a need to continually follow up on the effects of the regulation on the banks' behaviour and risk-taking, and on lending to non-financial corporations and households.

### 7.2 Feedback received

**The Confederation of Swedish Enterprise** expresses that there is currently a lack of information about how small non-financial corporations are affected by the increasing capital adequacy requirements, and wishes to point out that FI has an important task in following up and analysing how the smaller firms are affected by the rising capital adequacy requirements, and taking account of this in the implementation of the regulations.

**Kommuninvest** is of the opinion that the effects of the market impact that the capital requirements will have on the competitive situation on the market ought to be shown in the consequence analysis.

**The Financial Sector Union of Sweden** expresses that the consequence analysis lacks an investigation into the effects on the number of employment positions, price formation and consumption patterns. Furthermore, it lacks an analysis of the competitive situation in Sweden and the competitive disadvantages the banks will encounter abroad. The Union writes that a more

or less explicit objective shared by the government and FI is to substantially reduce the size of the Swedish banking system. This adjustment of an entire industry is being done without any investigation into the effects on employees and without any compensation for this, which the Financial Sector Union of Sweden finds unacceptable.

**The Association of Swedish Finance Houses** finds that the consequence analysis ought to contain a broader analysis covering the smaller and less specialised credit institutions, and consequences for competition on the market.

**The Swedish National Debt Office** points to the need to carry out a careful evaluation of the capital requirements now being introduced, and based on that also analyse what constitutes appropriate target levels for the capital requirements over time. Furthermore, the Debt Office expresses that in time, there is also a need to perform an overall analysis of the financial situation of households with a view to creating a more precise picture of the risks brought about by household indebtedness. Such an analysis constitutes an important sub-component in the assessment of which capital levels ought to apply for the banks in future.

**The Swedish National Savings Banks Organisation** writes that the consequences for small credit firms must be highlighted in order to provide an overarching picture of FI's proposal.

### **7.3 Effects for financial institutions**

#### **7.3.1 Firms affected**

The positions in this memorandum concern, at least to some extent, all firms covered by the capital adequacy regulations, which comprises all credit market companies, including banks, and investment firms, at both the individual and consolidated level.

#### **7.3.2 The total capital requirement and its components**

##### **7.3.2.1 Introduction**

In section 1.4, an overarching description is provided of the capital requirement's various components. The total capital requirement is regulated by the Capital Requirements Regulation, Swedish law and FI's regulations. It is also affected by the positions described in this memorandum.

As mentioned above, the forthcoming total capital requirement consists of a number of different parts. Some of these parts involve an equal increase in capital requirement levels for all firms. For example, the capital conservation buffer is the same level (2.5 per cent) for all firms. Other parts, such as the increased risk weight floor for mortgages, vary from firm to firm depending on their risk exposure and whether or not they use the IRB approach. The factors



influencing the capital requirement for an individual firm can, in general terms, be broken down into systemic importance, geographic distribution of lending, breakdown of lending by sector, use of the IRB approach and exposure to other risks not covered by Pillar 1.

### 7.3.2.2 Description of the calculations

The next chapter illustrates the estimated effects of the proposed applications for the ten largest Swedish credit firms. The reason for why smaller firms are not covered is that, in general, the consequences for such firms are primarily attributable to the introduction of regulations, directives and laws rather than the positions presented in this memorandum. Certain individual firms may however clearly be affected by FI's positions regarding the implementation of the supervisory capital assessment.

The effects have been estimated based on data reported to FI regarding the second quarter of 2014.<sup>45</sup> For the major banks, forecasts are also provided from forecasting service SME Direkt regarding profit and distribution for the remainder of the current financial year. However, the risk-weighted assets trend is not forecast.

The calculations pertain to the consolidated level. The capital planning buffer and the minimum capital requirement according to the Basel 1 floor are not reflected in the diagrams. Out of the ten firms included in the consequence analysis, eight are covered by the Basel 1 floor: the four major banks, Landshypotek, Länsförsäkringar, SBAB and SEK. The effects of the Basel 1 floor are accounted for in *Finansinspektionen's approach to the Basel 1 floor*<sup>46</sup>.

The size of the various components of the capital requirement has been estimated as follows.

Capital requirement under Pillar 2, excluding risk weight floor and systemic risk. A standardised value has been used, which is 2 per cent of the risk-weighted exposure amount in total own funds. The share to be covered by common equity Tier 1 capital is determined by the breakdown of type of capital according to Pillar 1 (including buffer requirements besides the countercyclical capital buffer) that applies to the major banks and other firms, respectively.

Current risk weight floor for mortgages. The increased risk-weighted exposure amount brought about by a risk weight floor of 15 per cent has been multiplied

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<sup>45</sup> The actual capital ratios for Handelsbanken and Nordea differ slightly from the banks' publicly reported figures for the second quarter. This is because these firms apply FI's advance authorisation to include interim results in accordance with Article 26(2) of the Capital Requirements Regulation in a different way when reporting to authorities, on which the analysis in this section is based, compared to the interim reports.

<sup>46</sup> Memorandum published on fi.se on 18 March 2014, FI ref. 13-13990.

by the relevant capital requirement that applies to the major banks and other firms, respectively, and which was stated in section 4.6.1.5. The countercyclical buffer rate of 1 per cent was used in the calculation. This means that the own funds requirement used in the calculation is 16.5 per cent for the major banks and 11.5 per cent for other firms. The common equity Tier 1 capital requirement used is 13 per cent for the major banks and 8 per cent for other firms.

Increase in the risk weight floor to 25 per cent. The increased risk-weighted exposure amount brought about by the increase has been multiplied by the capital requirement as above excluding the countercyclical buffer rate for Sweden.

Risk weight floor of 25 per cent for mortgages in Norway The increased risk-weighted exposure amount brought about by the floor has been multiplied by the capital requirement according to the same method as for the Swedish risk weight floor.

Systemic risk in Pillar 2. 2 per cent of the total risk-weighted amount for the major banks. Covered in its entirety by common equity Tier 1 capital.

Systemic risk buffer. 3 per cent of the total risk-weighted amount for the major banks. Covered in its entirety by common equity Tier 1 capital.

Countercyclical capital buffer. The countercyclical buffer rate of 1 per cent has been used in the calculation. The firm-specific buffer rate has been estimated on the basis of reported data received according to the EU-wide instructions for Common Reporting (COREP) as per the second quarter of 2014. The share of concerned credit exposure in Sweden of each firm has been estimated as follows<sup>47</sup>:

- Handelsbanken: 49 per cent
- Nordea: 19 per cent
- SEB: 34 per cent
- Swedbank: 57 per cent
- Landshypotek: 91 per cent
- Länsförsäkringar: 99 per cent
- Kommuninvest: 68 per cent
- SBAB: 87 per cent
- SEK: 40 per cent
- Skandia: 41 per cent

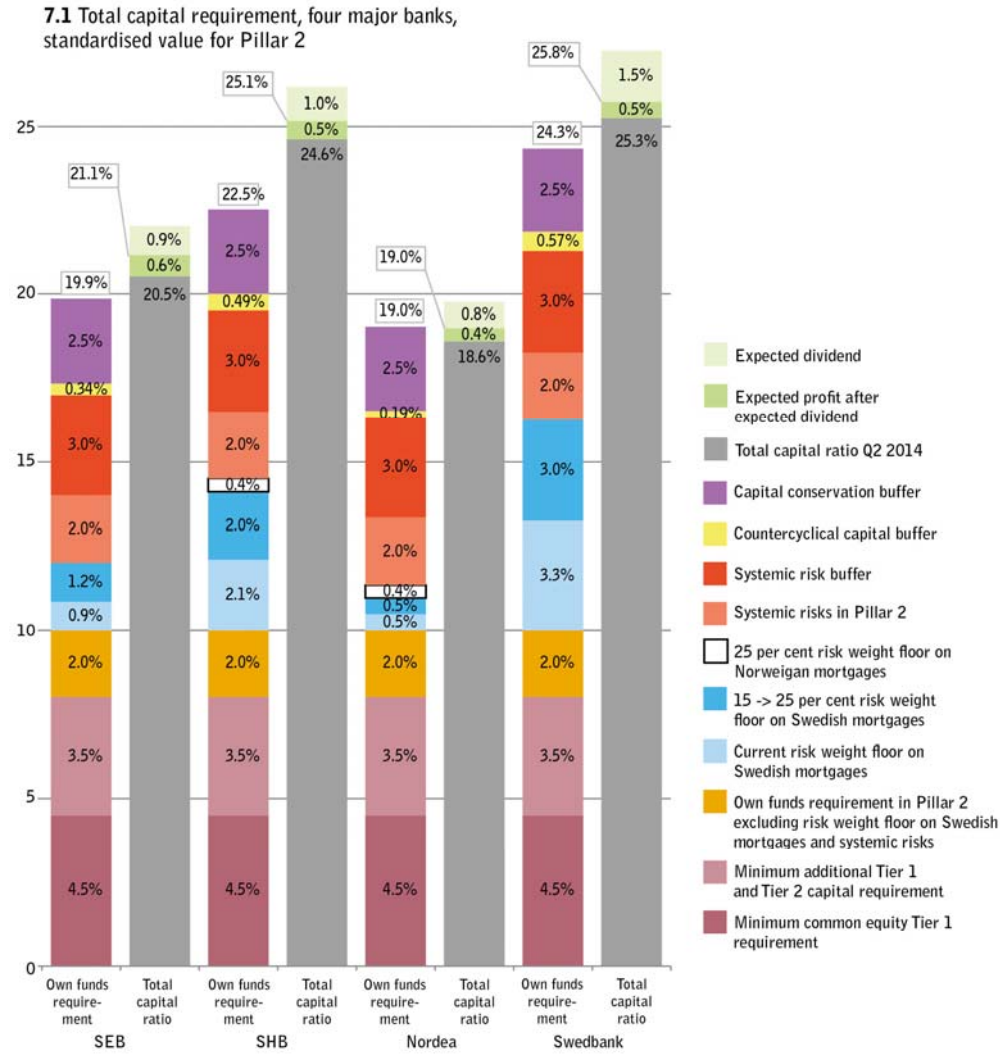
In order to calculate the firm-specific buffer rate, the share of the concerned credit exposure in Sweden, as above, is multiplied by the countercyclical buffer

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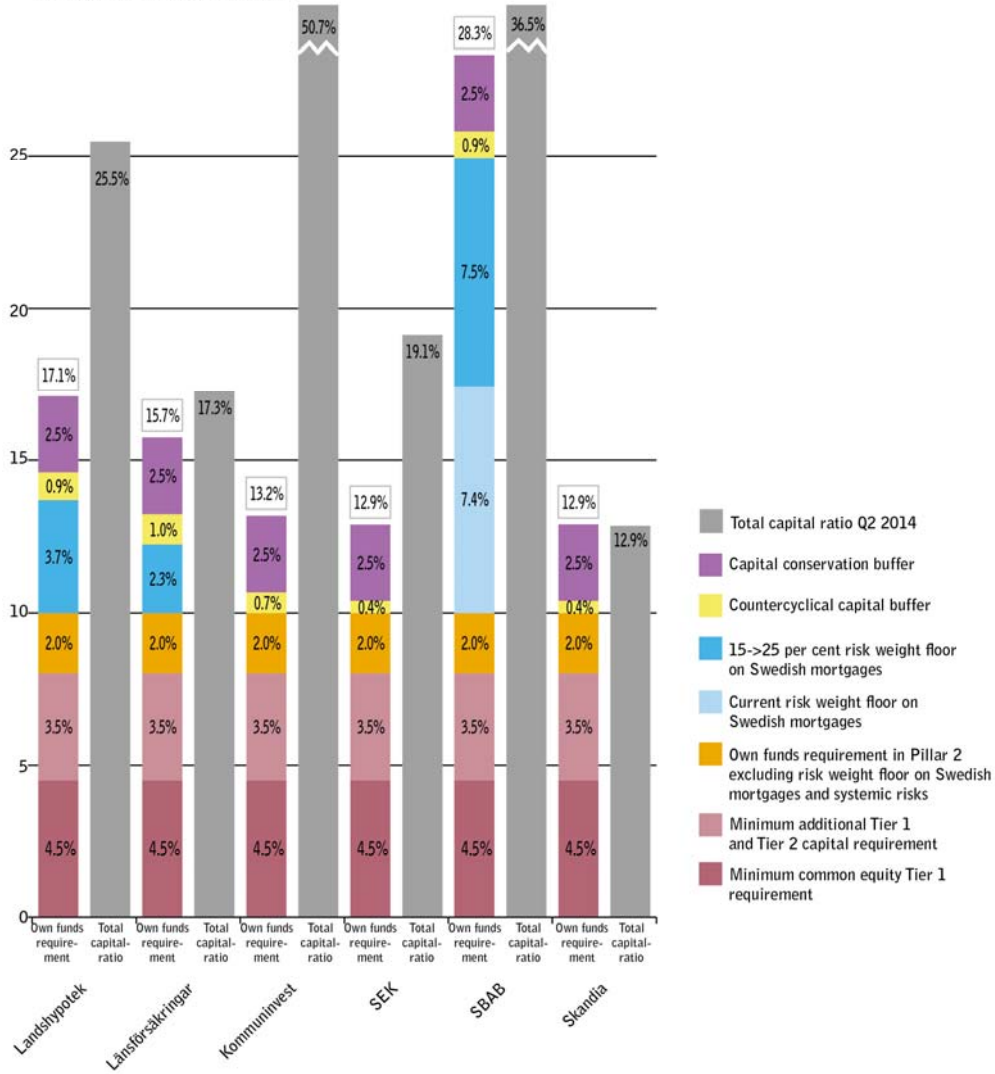
<sup>47</sup> The geographic breakdown can differ slightly from that given in EBA's proposal for a technical standard for this calculation, so the information should only be considered as an estimate of the correct breakdown to this end.

rate of 1 per cent. Buffer rates for other countries have not been taken into account.

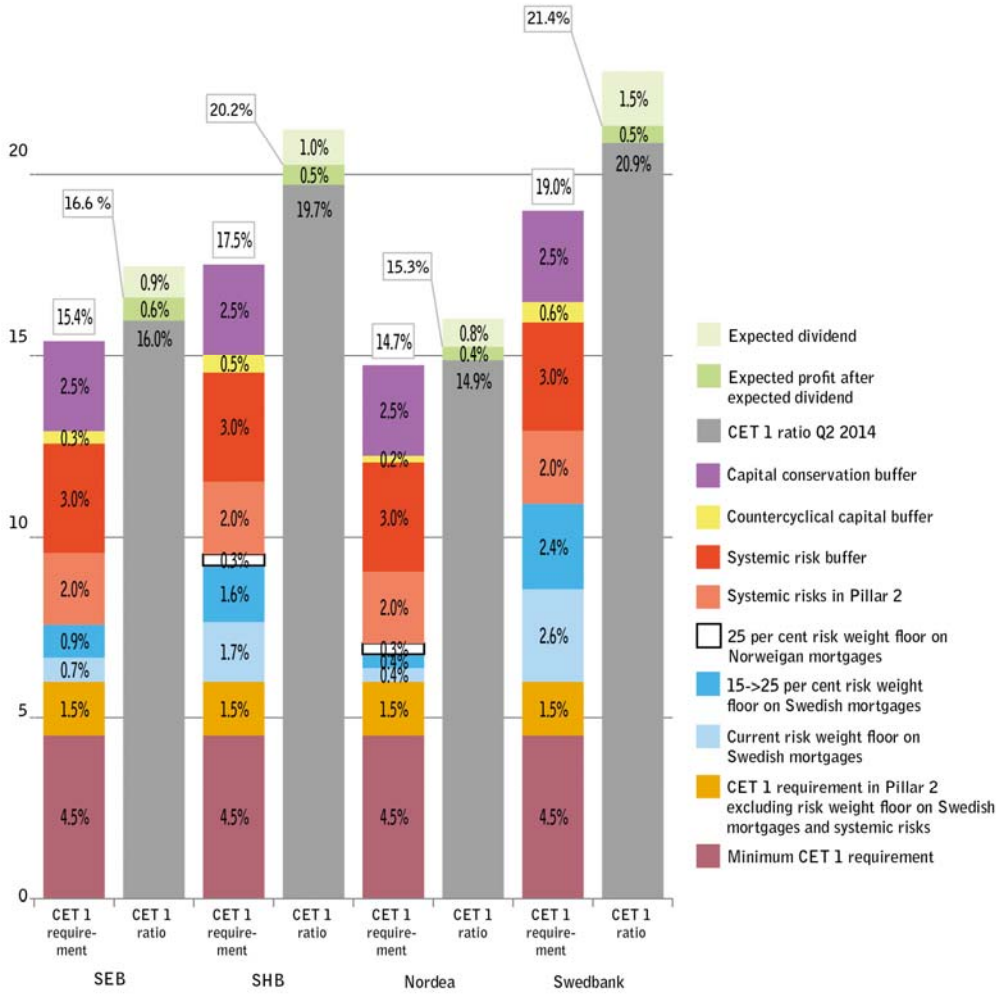
Capital conservation buffer. 2.5 per cent of the total risk-weighted exposure amount. Covered in its entirety by common equity Tier 1 capital.



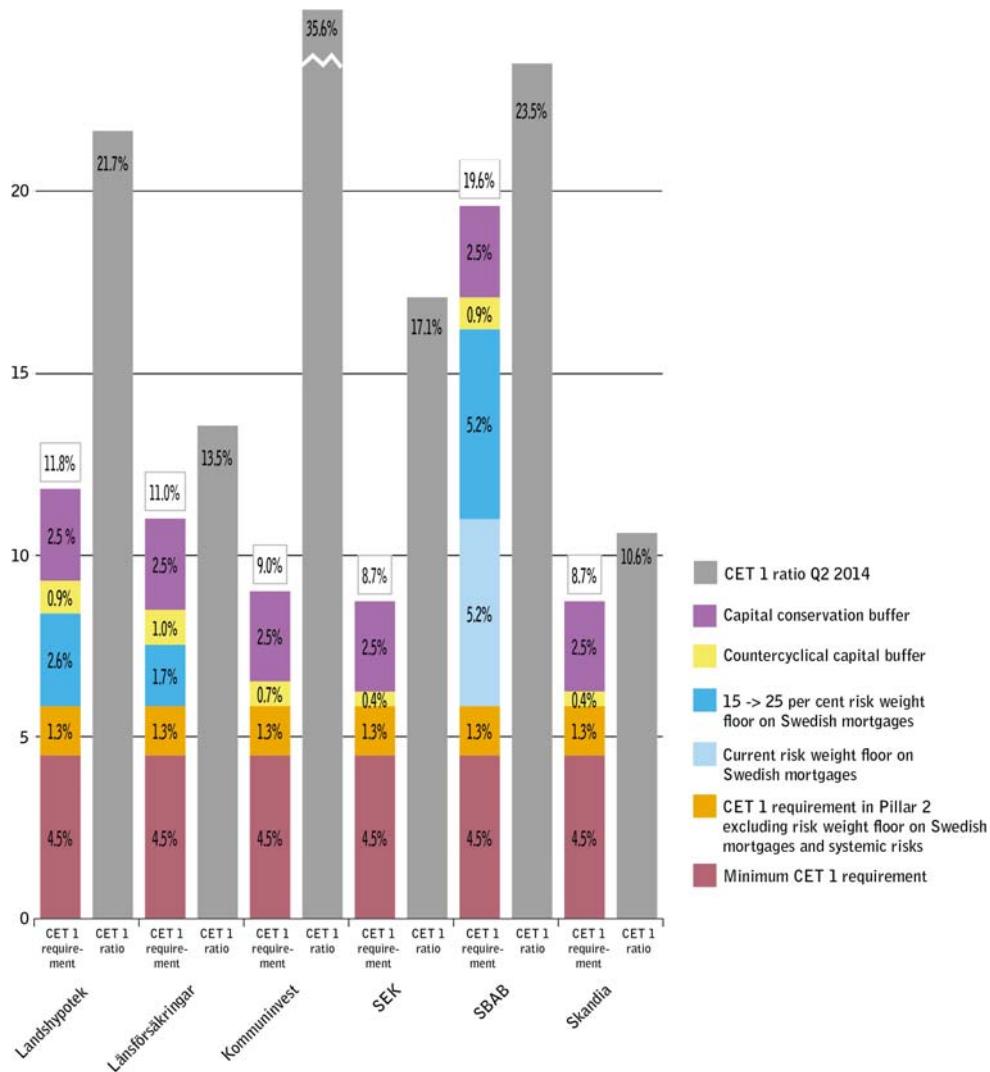
7.2 Total capital requirement, other six firms, standardised value for Pillar 2



**7.3 Common equity Tier 1 (CET 1) capital requirement, four major banks, standardised value for Pillar 2**



7.4 Common equity Tier 1 (CET 1) capital requirement, other six firms, standardised value for Pillar 2



In table 7.1 the various capital need components are expressed in Swedish kronor. The basis of the calculations is the same as for the diagrams above.

### 7.1 The components of the 10 firms' capital need in SEK million

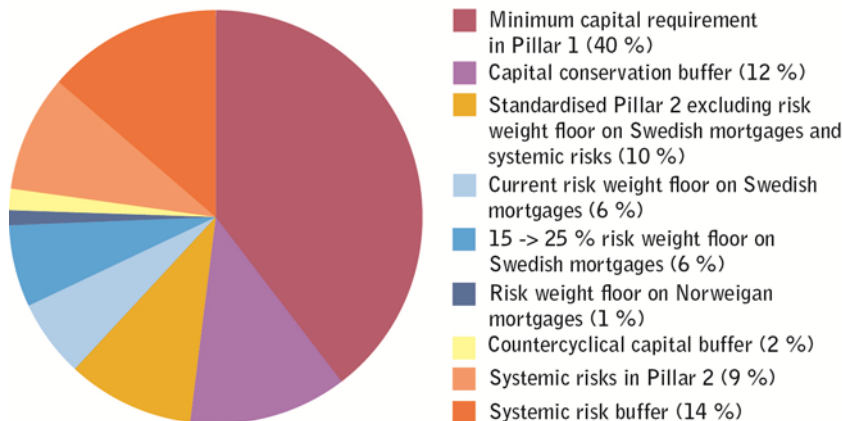
	Nordea	SEB	Swed- bank	SHB	SBAB	SEK	Länsför- säkringar	Skandia	Lands- hypotek	Kommun- invest	Sum
Minimum capital requirement Pillar 1 (8%)	111 732	47 853	32 534	39 764	3 191	6 934	4 686	3 214	1 471	529	<b>251 908</b>
Capital conservation buffer (2.5%)	34 916	14 954	10 167	12 426	997	2 167	1 464	1 004	460	165	<b>78 721</b>
Standardised value Pillar 2, ex. risk weight floor and systematic risk (2%)	27 933	11 963	8 133	9 941	798	1 733	1 171	804	368	132	<b>62 977</b>
Current risk weight floor on Swedish mortgages (15%)	6 750	5 100	13 251	10 450	2 966	0	0	0	0	0	<b>38 517</b>
15 -> 25 % risk weight floor on Swedish mortgages	6 727	6 931	12 263	9 973	2 992	0	1 320	0	679	0	<b>40 884</b>
Risk weight floor on Norwegian mortgages (25 %)	5 401	6	2	1 983	0	0	0	0	0	0	<b>7 392</b>
Countercyclical capital buffer (1.0%)	2 636	2 056	2 317	1 983	349	351	579	163	167	45	<b>10 647</b>
Systemic risks in Pillar 2 (2 %)	27 933	11 963	8 133	9 941	0	0	0	0	0	0	<b>57 971</b>
Systemic risk buffer (3%)	41 899	17 945	12 200	14 911	0	0	0	0	0	0	<b>86 956</b>
<b>Total own funds requirement</b>	<b>265 927</b>	<b>118 771</b>	<b>99 000</b>	<b>111 372</b>	<b>11 294</b>	<b>11 185</b>	<b>9 220</b>	<b>5 186</b>	<b>3 144</b>	<b>872</b>	<b>635 972</b>

Note: Calculated using data per Q2, 2014.

The minimum total capital requirement according to Pillar 1, excluding buffer requirements, equalled 40 per cent of the combined total capital need of the 10 largest Swedish banking groups. The two parts of the risk weight floor for Swedish mortgages equalled 12 per cent on the whole, while the countercyclical capital buffer decided at 1 per cent accounts for just shy of 2 per cent of the combined total capital need. The minimum total capital requirement amounts to just over SEK 250 billion on the whole for the ten firms, while the various buffer requirements and capital need, according to the standard for Pillar 2, contributes a further amount of just over SEK 380 billion to the capital need. Hence, on the whole the total capital requirement amounts to just shy of SEK 640 billion.

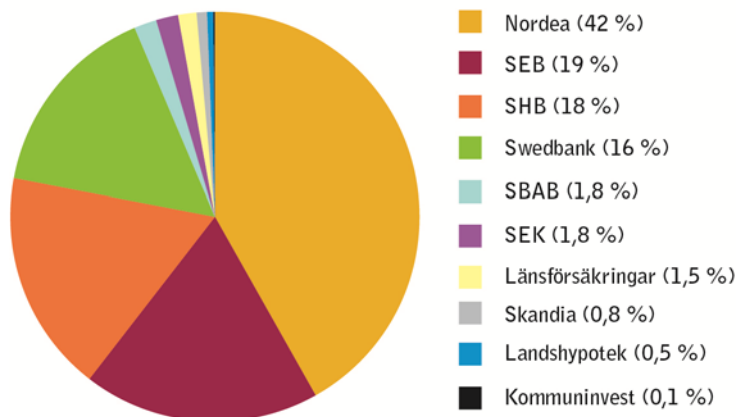


**7.5 Breakdown of the components of the 10 largest firms' combined total capital need**



The total capital need of the four major banks equalled almost 94 per cent of the sum total of the ten largest Swedish credit firms. Nordea’s capital need accounted for almost 42 per cent of the sum total.

**7.6 Breakdown of the combined total capital need between the 10 firms**



**7.3.3 Adaptation of the firms**

The question as to how higher capital levels in the banking sector might perceivably affect the banks’ capital cost, funding cost and, ultimately, the cost for their customers, is important yet difficult. According to financial theory, the capital structure of a firm should not affect its value because the firm’s total funding cost is not affected by the relationship between capital and liabilities.<sup>48</sup>

Because higher capital levels reduce risk for lenders, the banks’ loan financing cost is reduced. However, this theory is based on certain assumptions and does not take account of, for instance, the tax benefits of loan financing compared

<sup>48</sup> See e.g. Modigliani, F.; Miller, M. (1958). “The Cost of Capital, Corporation Finance and the Theory of Investment”. *American Economic Review* 48 (3): 261–297.

with equity. Furthermore, it is less applicable to credit firms due, for instance, to the Government's implicit and explicit guarantees for the liabilities of the banking system. New regulations, not least the Crisis Management Directive<sup>49</sup>, also provide new conditions for both lenders of and investors in own fund instruments, so the funding strategies of banks might hence change.

The firms concerned only have a short space of time to adapt their capital planning and hence their capital targets to the total capital requirements. In FI's opinion, the firms affected will be able to meet the requirements. At the same time, because of the need for continuing adaptation, certain firms need to be conservative in their capital planning and show restraint in measures that weaken their resilience, such as profit distribution and share buybacks.

#### **7.4 Consequences for competition and the market**

FI has, in its dialogue with the banks, emphasised for a long time the necessity of forward-looking capital planning, that allows for the higher levels that would ensue from new regulations. In cases where the current capital level does not cover the capital need, FI is of the opinion that capital reinforcement can mainly be achieved by means of restraint in dividends and share buybacks, rather than reducing operations. Also, several firms are able to increase their total own funds by issues of own fund instruments that may be included in Tier 1 or Tier 2 capital. On the whole, this implies that the positions taken by FI ought not to entail the firms needing to make any substantial changes to their operations in order to adapt. FI continually monitors the firms' capital strength, funding, lending, profitability and so on and is also in regular dialogue with the firms. Hence, FI has the possibility of detecting unforeseen consequences of new regulations and applications at an early stage .

According to the new buffer structure, the capital requirements vary between different types of credit firms. The ensuing greater difference between e.g. larger and smaller firms might in itself be positive for competition in that it counteracts the effect of implicit government guarantees for systemically important firms, which has also been discussed in section 3.3.4. The competitive advantages of the systemically important firms can thus be expected to decrease with the regulations. Another aspect of the new buffer structure is the increased countercyclical feature of the capital requirements.

At the same time, all else equal, the introduction of stricter capital requirements brings greater incentives for firms to adapt their operations with the purpose of reducing the requirements. When capital requirements for mortgages rise, the alternative of, for instance, securitisation might appear more profitable compared to keeping the loans on the balance sheet. Here, FI wishes to point

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<sup>49</sup> The Directive of the European Parliament and of the Council establishing a framework for the recovery and resolution of credit institutions and investment firms and amending Council Directives 77/91/EEC, 82/891/EC, 2001/24/EC, 2002/47/EC, 2004/25/EC, 2005/56/EC, 2007/36/EC, 2011/35/EC and regulation (EU) no. 1093/2010.

out that FI, like Swedbank (see section 4.4) finds that the Swedish model in which the firms that issue mortgages also keep them on their balance sheet, implying that the firms themselves take the risk of any credit losses, has worked well historically. When the requirements increase for Swedish exposures, the possibilities of expansion abroad might also appear relatively more attractive.

On the whole, FI believes that the effects on competition and the market will be limited, but probably positive, particularly as a result of the reduced uniformity in capital levels between larger and smaller institutions. An important task for FI will be to monitor, in its supervision, the effects of the regulations on the operations and risk management of firms.

## **7.5 Consequences for non-financial corporations and households**

When the banks adapt to higher capital requirements, the funding cost might rise because capital is usually a more expensive form of funding than loans, as described in section 7.1. It is difficult to evaluate the effects of the capital rules on lending volumes and interest rates for households and non-financial corporations. This is due to the uncertainty surrounding the consequence for the total capital and funding cost of the credit firms – a higher share of equity can reduce the cost of other funding – and to credit firms making business decisions on grounds other than regulations alone. Furthermore, the banks react to events on the funding market. There is reason to believe that higher capital requirements affect total funding costs in different ways depending on the state of the capital market and the capital strength of the firms to start with. In cases where regulation brings increased costs for the credit firms, it can affect households and non-financial corporations in the form of lower lending volumes or higher lending rates, which can in turn lead to reduced consumption and investment.

By reason of the viewpoints received, FI wishes to point out that the authority conducts continual work on analysing lending in society and credit terms for corporations and households, and developments in setting interest rates and the various components of the latter. This includes studying the effects of the capital adequacy rules for SMEs. This work is reported in, for example, FI's half-yearly stability report and annual mortgage survey.

In terms of the effects on mortgages specifically, it can be ascertained that the increase to the risk weight floor from 15 per cent to 25 per cent involves an appreciable increase to the capital requirement. Firms authorised to use the IRB approach for Swedish mortgages, and which are hence covered by the floor, dominate the Swedish mortgage market. FI believes that the higher share of capital required for mortgage operations increases the marginal cost of the credit firms for new mortgages, and will hence limit supply somewhat, all else equal.

## 7.6 Consequences for the economy

### 7.6.1 Introduction

The forthcoming capital adequacy regulations force the banks to hold a large amount of capital of better quality, and can lead to economic costs in the form of effects on lending rates for households and non-financial corporations. It is, however, important to bear in mind that this does not necessarily involve reduced economic benefit.

### 7.6.2 Higher capital costs have a negative effect on GDP

The assumptions made regarding the allocation of costs between the banks' owners and customers affect the assessment of how the rules will affect the economy. There are therefore several different assessments of the scope of the effects. The Riksbank has, for example assessed that loan margins will increase by 0.13 per cent if common equity Tier 1 capital as a share of risk-weighted assets in Swedish banks increases by 1 percentage point. Such an increase is expected to give rise to 0.06–0.16 per cent lower GDP over time.<sup>50</sup> The effects calculated by the Ministry of Finance suggest that the GDP level will decrease by around 0.3 per cent when the capital level increases by one percentage point.<sup>51</sup> Uncertainty in the assessments is substantial, however, one reason being that the increase to loans is affected by assumptions about risk weights, the return requirements of shareholders, etc. More stable banks and other credit firms should, as previously mentioned, also be able to obtain better terms from their creditors. Swedish credit firms currently have sound resilience, and because of that they have access to funding on decent terms.

### 7.6.3 Higher capital requirements increase resilience and reduce the risk of financial crises

The regulation of banks' capital chiefly aims to make the financial system more stable and reduce the risk of future banking and financial crises, and also potentially their scope. Because such crises tend to have major negative effects on the economy, reducing the probability of them occurring is important. On top of that, higher capital requirements reduce the risk of having to use public funds to prop up financial institutions in crisis.

There are a number of channels through which banking and financial crises affect the real economy. Crises can for instance give rise to negative wealth effects, credit contraction, reduced scope for investments and consumption, and ultimately also lead to sovereign debt crises. According to the calculations of the International Monetary Fund (IMF), the costs of the crisis for European

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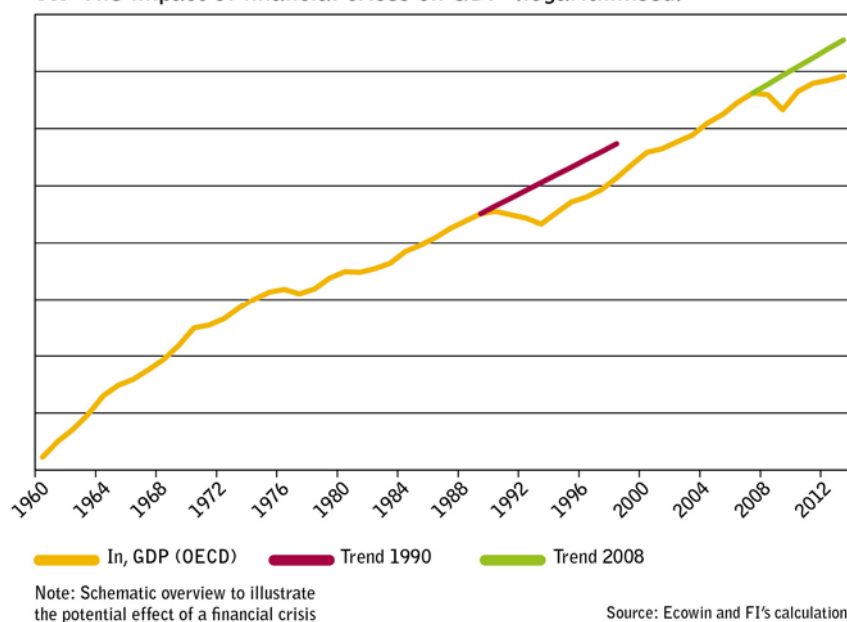
<sup>50</sup> See Appropriate capital ratio in major Swedish banks – an economic analysis, December 2011, the Riksbank.

<sup>51</sup> See proposal 2013/14:228, page 263.).

banks during 2007–2010 amounted to almost EUR 1,000 billion, or 8 per cent of the EU's GDP.

The negative effects of banking and financial crises also tend to be protracted, and in certain cases permanent. For example, it is assumed that the crisis in Sweden of the 1990s and the 2008 financial crisis have had a long-term negative effect on the Swedish economy.<sup>52</sup>

### 7.7 The impact of financial crises on GDP (logarithmised)



On top of the forthcoming capital adequacy requirements, regulatory work is currently in progress, as mentioned above, with the aim of improving the possibilities of the Government to prevent, deflect and manage banking crises with the purpose of reducing the risks for taxpayers and costs to the economy. For example, the Crisis Management Directive enables bail-in (the ability to impair the liabilities of banks). The effects of these future rules are hard to evaluate today, however.

#### 7.6.4 *Appropriate capital levels with respect to the economy*

Given that the regulations have the intended effect and reduce the risk of future banking and financial crises, there is thus reason to believe that higher capitalisation in the banking system can have a positive long-term effect on GDP. However, quantifying the effect of a more stable banking sector requires a number of assumptions, and is associated with a high degree of uncertainty. In 2010 the Basel Committee was of the opinion that a 1 percentage point

<sup>52</sup> The Swedish Economy, March 2010, *the National Institute of Economic Research*.

lower risk of a banking crisis increases expected GDP by 0.6–1.6 per cent over time.<sup>53</sup>

A number of studies have attempted to assess appropriate capital levels with respect to the economy based on weighing the costs associated with higher capital costs against a reduced risk of financial crises. Several studies indicate optimal common equity Tier 1 capital levels of 10–20 per cent.<sup>54</sup> In the 2011 study referred to previously, the Riksbank also made an estimation of the effect of the regulations on the probability of a banking crisis in Sweden. In the study, it is ascertained that a higher capital adequacy ratio reduces the risk of such crises, but the effect wanes when the original capital level is high. Raising the capital adequacy ratio of banks that are already well-capitalised thus has less of an effect than increasing the capitalisation of banks with low capital adequacy ratios. The studies do not address, however, the positive effect of reduced distortions on the economy. A reduction in the Government's implicit guarantees reduce the misplaced incentives they create, and hence entails an efficiency gain for the economy. As the Swedish National Debt Office points out in its viewpoints, further analysis of appropriate capital levels is required, however. FI intends to continue publishing such analyses going forward.

## 7.7 Conclusion

The November Accord reflects the view of Swedish authorities of the major Swedish banks and the Swedish banking system having specificities that motivate a higher capitalisation interval for them. In FI's opinion, the overall requirements create sound resilience in the Swedish banking sector. This ought to lead to a lower risk of financial crises and reduced distortion as a result of Government guarantees. However, it is crucial to continually monitor the effects of the requirements, which FI intends to do in its supervision and address in forthcoming stability reports.

On the whole, the implementation of the strengthened capital adequacy rules involves a clear tightening of capital requirements for Swedish banks, particularly the systemically important major banks. At the same time, it can be ascertained that international efforts to further strengthen the capitalisation of the banking system are progressing. For example, a leverage ratio measure will be introduced, potentially as a compulsory requirement as of 2018. The Basel Committee is also working on preparing proposals to standardise risk weight calculations with the aim of limiting the disparities between the internal models of different banks. Another important aspect is how the Crisis Management Directive will be implemented and applied, since it might involve requirements being imposed on the loss-bearing capacity a systemically important bank must have in the event of it succumbing to resolution.

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<sup>53</sup> See An assessment of the long-term economic impact of stronger capital and liquidity requirements, August 2010, *Basel Committee on Banking Supervision*.

<sup>54</sup> Bank of England (2010), Macroeconomic Assessment Group (2010), Institute of International Finance (2011), LEI report (2010), Miles et al. (2011).