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CONSULTATION MEMORANDUM

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New capital requirements for Swedish banks

Summary

Finansinspektionen (FI or the authority) is proposing changes to the authority's application of Swedish banks' capital requirements due to the upcoming implementation of changed capital requirement regulations from the EU's so-called banking package. The proposal on how the Swedish legislation will be changed can be found in the report "EU:s bankpaket om riskreducerande åtgärder" (SOU 2019:60) and in the proposed bill "Ändringar i regelverket om kapitaltäckning".[1] Any changes that may occur during the drafting of the proposed bill will need to be considered for final application.

Several regulatory amendments will be introduced in the next few years including the EU implementation of the Basel Accord, which will complete Basel III. It may therefore be necessary for FI to revisit the design of the capital requirements in light of these amendments.

This memorandum describes how the new capital requirements will be applied and replaces the implementation memorandum that FI issued in 2014.[2]

Changes to the risk-based capital requirement

As a whole, the banking package will require banks to simultaneously meet two parallel capital requirements in the form of risk-based requirements and leverage ratio requirements.

The risk-based capital requirement consists of four main components:

1. *Minimum requirement.* Unchanged at 8 per cent of risk-weighted assets.

2. *Additional own funds requirement* (the Pillar 2 requirement). FI will be able to continue to decide on an additional own funds requirement under Pillar 2 for risks that a bank is, or may be, exposed to and which are not covered by the minimum requirement. A new aspect is that the

[1] Not available in English. The title of the report is translated as "EU's Banking Package on Risk Reduction Measures". The title of the bill is translated as "Changes in the capital requirement regulation".
[2] Kapitalkrav för svenska banker, FI Ref. 14-6258, September 2014, https://www.fi.se/contentassets/91a11ceca3f54525a4a0a24dbb514cf5/kapitalkrav-svenska-banker-140910ny.pdf. An English translation is available at www.fi.se.

additional own funds requirement will always be determined by a formal decision for each bank.

FI intends to continue to be transparent about its assessment of the risks the banks are exposed to and will therefore continue to publish the assessment methods used by the authority. However, FI is proposing to both clarify, and in some cases, update the current methods. The authority also intends to remove the 2 per cent add-on for systemic risk in Pillar 2 since Pillar 2 requirements will only be able to cover risks that the bank is, or may be, exposed to individually, as well as to take into account other changes within the banking package that raise the capital requirements. FI also proposes that the assessment method "Kapitalkrav inom pelare 2 avseende löptidsantaganden" (FI Ref. 16-2703)[3] no longer be applied, primarily to avoid making the application more complex than necessary.

3. *Combined buffer requirement.* This consists in practice of several buffers: the buffer for other systemically important institutions (the O-SII buffer), the systemic risk buffer, the countercyclical buffer, and the capital conservation buffer.[4] The calculation of the combined buffer requirement will be changed by law, so that the O-SII buffer, in contrast to today, will be additive to the systemic risk buffer.[5] The limitations on what risks may be managed in Pillar 2 will thus be balanced by greater possibilities for managing risks through the combined buffer requirement.

   This memorandum clarifies that the O-SII buffer reflects how important the individual bank is for the system. FI is proposing that the O-SII buffer be lowered from 2 per cent to 1 per cent at the group level for the three major banks. FI is also proposing that the systemic risk buffer remain at 3 per cent at the group level for the three major banks.[6]

4. *Guidance in Pillar 2*. Through this guidance FI can inform a bank which additional capital the authority expects the bank to hold over and above the other main components to cover risks and manage future financial stresses. FI will communicate to the bank the expectation of this risk-based guidance if the authority considers the capital

[3] A translation of the memorandum into English is available at fi.se, "Pillar 2 capital requirements for maturity assumptions".
[4] There is also a buffer for global systemically important institutions (G-SII), but this buffer is not described since Sweden currently does not have any institutions of this category.
[5] In simplified terms, the current regulations state that the higher of the systemic risk buffer and the O-SII buffer applies.
[6] Nordea Hypotek AB will also continue to have an O-SII buffer of 0 per cent. The bank is subject, however, to an O-SII buffer of 2 per cent that the Finnish supervisory authority assigns to Nordea Bank Abp at group level.

conservation buffer to be insufficient for covering the risks to which the individual bank is exposed.

The Pillar 2 guidance replaces the capital planning buffer, which FI applies today. Currently, FI makes the assessment that the level of Pillar 2 guidance for most banks is likely to amount to around 1–1.5 per cent of their risk-weighted assets. However, this figure could vary between banks and be significantly higher for some, usually smaller, more specialised banks. FI is also proposing that the guidance, like the current capital planning buffer, must be met with Common Equity Tier 1 capital, the capital FI assesses to be the most useful in the presence of a financial stress.

Changes due to the leverage ratio requirement

The banking package introduces a leverage ratio requirement that will function as a backstop for how low the capital requirement may be. The total leverage ratio requirement is based on equivalent main components that correspond to those for the risk-based capital requirement.

The minimum leverage ratio requirement is 3 per cent of the total exposure amount. In addition, FI may decide on an institution-specific *additional leverage ratio requirement* within Pillar 2. FI intends to only decide on an institution-specific additional leverage ratio requirement if special grounds exist. Most banks will therefore not be subject to such a requirement. FI also is entitled to inform a bank how much capital the authority intends for the bank to hold in addition to the other components to cover risks and manage financial stresses.[7] FI is proposing that this *leverage ratio guidance* be met with Common Equity Tier 1 capital in order to maximise the ability to absorb losses. Currently, FI makes the assessment that the guidance for most banks will be around 0.2-0.5 per cent of the exposure amount for the leverage ratio. This figure could vary between banks.

For the major banks, in line with other capital requirements, FI intends to make public its expectations for the level of Pillar 2 guidance.

Impact of the banking package

The impact of the implementation of the banking package in Sweden will differ depending on the bank. [8] For the major banks that are already subject to extensive systemic risk requirements, the total risk-weighted capital

[7] The leverage ratio buffer that is introduced in the Capital Requirements Regulation only applies to global systemically important institutions. As a result, no Swedish bank is currently subject to this buffer.

[8] The assumptions underlying the impact analysis include, for example, a risk-based Pillar 2 guidance of 1 per cent and a leverage ratio guidance of 0.35 per cent.

requirement is not expected to be significantly affected.[9] Mid-size and smaller banks are expected to overall experience an increase in their capital requirement of approximately 5–10 per cent, but the effect will vary by bank. For some banks in Category 2, the capital requirement will be predominately impacted by the leverage ratio requirement.[10] For Category 3 and Category 4 banks, the increase is largely due to the introduction of the risk-based Pillar 2 guidance to the extent the banks have not already been assigned one through a capital planning buffer. These impact assessments do not take into account the capital requirement relief elements of the banking package.[11]

It should be noted in particular that the leverage ratio requirement has a large impact and in many cases results in it not being possible to fully utilise the risk-based buffers without breaching the leverage ratio requirement’s minimum requirement. The risk-based buffers, therefore, cannot be used to the same extent. For some banks that have low risk-weighted capital requirements, the leverage ratio requirement will be the most restrictive requirement.

FI makes the assessment that proposals in this memorandum will not require the banks to change their business to any significant extent in order to adapt. For the few banks that currently have capital levels that are insufficient for the future capital requirement, FI makes the assessment that these banks will be able to reinforce their capital primarily through retained earnings instead of raising new funding.

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[9] The major banks are currently subject to systemic risk buffers of 5 per cent through a 2 per cent systemic risk add-on in Pillar 2 and a 3 per cent systemic risk add-on in Pillar 1. The proposed change entails that the major banks will be subject to a systemic risk buffer of 3 per cent in Pillar 1, an O-SII buffer of 1 per cent, and a Pillar 2 guidance that is estimated to be 1–1.5 per cent. The level for when the automatic restrictions on value transfers go into effect therefore increases by 1 percentage point. For further information, see section 6.2.2.

[10] The banks are divided into different categories. Mid-size and smaller banks includes Categories 2, 3 and 4.

[11] For example through the implementation of an expanded supporting factor on risk-weighted assets for exposures to small and mid-size businesses.