04/07/2019

M E M O R A N D U M

Finansinspektionen
Box 7821
SE-103 97 Stockholm
[Brunnsgatan 3]
Tel +46 8 408 980 00
Fax +46 8 24 13 35
finansinspektionen@fi.se
www.fi.se

Liquidity coverage ratio requirements in individual currencies and FI's view on diversification of covered bonds in the liquidity buffer

This revised version replaces the memorandum "FI:s pelare 2-krav på likviditetstäckningskvot i enskilda valutor" (FI Ref. 17-12809) that was published on 19 April 2018 (in Swedish only).

Summary

Finansinspektionen (FI) describes its view on specific liquidity coverage ratio (LCR) requirements in individual currencies and provides its interpretation of the requirement for diversification of the composition of the liquidity buffer as it applies to Swedish covered bonds[1]. FI intends to apply these positions in its supervision of institutions[2] that belong to Supervision Categories 1 and 2 starting from 1 October 2019.

The LCR Regulation's[3] liquidity coverage ratio requirements have applied at an aggregate currency level of 100 per cent within the entire EU since 1 January 2018. The same regulation sets out general requirements concerning the currency denomination of the liquidity buffer and operational requirements regarding diversification of liquid assets in the liquidity buffer. In this memorandum, FI describes its view on the requirements in the EU regulation.

FI will also continue to apply the previously communicated requirement that banks in Supervision Categories 1 and 2 comply with a liquidity coverage ratio in EUR and USD that each amount to at least 100 per cent, provided that these currencies are significant[4] for the bank in question.

[1] "Covered bonds" denotes bonds that are issued by Swedish issuing institutions and where the cover pool consists of loans granted against real property, site leasehold rights or tenant-owner rights in Sweden.
[2] Credit institutions are addressed collectively in this memorandum and are referred to as banks or institutions.
[3] Commission Delegated Regulation (EU) 2015/61 of 10 October 2014 to supplement Regulation (EU) No 575/2013 of the European Parliament and the Council with regard to liquidity coverage requirement for Credit Institutions (LCR Regulation).
[4] A currency is significant if it amounts to at least five per cent of the bank's total liabilities in accordance with Article 415(2) (a) of the Capital Requirements Regulation.

- FI will also be applying a liquidity coverage ratio requirement of at least 75 per cent for every other individual currency, including SEK, provided that the currency is significant for the bank in question.

The LCR Regulation allows banks' liquidity buffers to contain a large proportion of covered bonds while also stipulating operational requirement that the composition of the liquid assets in banks' liquidity buffers must be diversified. FI's analysis of banks' reporting of liquid assets shows that there are some concentrations in holdings of Swedish covered bonds. Accordingly, FI makes the assessment that there is a need to report its interpretation of what the diversification requirement entails for the share of covered bonds[5] issued by Swedish issuers that banks are permitted to include when calculating the liquidity coverage ratio.

- FI's interprets the diversification requirement to mean, among other things, that the share of covered bonds issued by Swedish issuers that may be included in the liquidity buffer may amount to a maximum of 50 per cent of the total liquidity buffer when calculating the liquidity coverage ratio.

The impact of these positions with regard to liquidity coverage ratio in individual currencies and the diversification of the liquidity buffer is relatively limited. Most banks already comply with these requirements and have done so since the autumn of 2018.

Some banks have a liquidity buffer that consists of more than 50 per cent Swedish covered bonds, but they also have high liquidity coverage ratios. As a result, they experience a reduction in their liquidity coverage ratio after excluding the excess volume of Swedish covered bonds from the calculation. Even when these bonds have been excluded, the banks still meet the minimum liquidity coverage ratio requirement.

Under the diversification requirement set out in the LCR Regulation, banks must also ensure that their liquidity buffers are not excessively exposed to any one individual institution that issues covered bonds. This is because the issuers' risk exposure is heavily concentrated in Swedish mortgages, which may have an impact on the potential to liquidate the bonds if shocks were to occur in the housing or mortgage markets.

FI is clarifying its view on the liquidity regulations to ensure that banks have greater resilience to short-term liquidity stress in individual currencies and their liquidity buffers. FI is also clarifying the requirements in the regulations on the currency denomination of the liquidity buffer in relation to net outflow and the diversification of the liquidity buffer's composition.

Table of Contents

1 Background

1.1 Purpose

In this memorandum, FI describes the method it will be applying in its supervision of banks' liquidity coverage ratios in individual currencies within the scope of Pillar 2[6]. This supervision is part of the annual process in which FI assesses individual banks' risks, known as the supervisory review and evaluation process (SREP), which results in FI placing specific requirements on individual banks' capital and liquidity. FI also describes its view on the implications of the requirement for diversification of the liquidity buffer for banks. FI's interpretation of these points will be used in its supervision from 1 October 2019.

1.2 Background

In December 2010, the Basel Committee decided on a new global framework to strengthen banks' capital adequacy and liquidity positions.[7] One of the measures was to determine a quantitative minimum requirement on current liquidity coverage, which is called the liquidity coverage ratio (LCR). The aim of this kind of quantitative requirement is to strengthen banks' resilience to current liquidity shocks by ensuring that they hold sufficient high-quality liquidity buffers. According to the LCR requirement, a bank must hold a sufficiently large buffer of liquid assets to be able to withstand future cash outflows for a period of 30 days while experiencing heavy liquidity stress.

In July 2013, the EU published the Capital Requirements Regulation[8] (CRR) and the Capital Requirements Directive[9] (CRD). The CRR includes binding provisions on liquidity coverage based on the Basel Committee's standard from 2010. Following the publication of the CRR, the European Commission was empowered to adopt a delegated regulation in order to provide further detail concerning the requirement.

FI's regulations (FFFS 2012:6) regarding requirements on the liquidity coverage ratio and reporting of liquid assets and cash flows entered into force on 1 January 2013 (the liquidity regulations). The Swedish liquidity coverage requirement was based on the Basel Committee's standard from 2010 because

[6] Pillar 2 is the umbrella term for the rules that govern banks' internal capital and liquidity assessments and FI's supervisory review and evaluation process.
[7] Basel III: A global regulatory framework for more resilient banks and banking systems, Basel Committee on Banking Supervision, December 2010, https://www.bis.org/publ/bcbs189.pdf
[8] 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.
[9] 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 2006/49/EC.

the requirement under the CRR was not specified at the time the liquidity regulations were introduced.[10] The European Commission published a delegated regulation, the LCR Regulation, in October 2014. The final requirement level in the LCR Regulation of 100 per cent came into force on 1 January 2018 as a binding minimum requirement in the EU. At that time, FI's liquidity regulations and FI's regulations (FFFS 2011:37) regarding the reporting of liquidity risks for credit institutions and investment firms were repealed.[11]

2 Legal basis

2.1 Additional liquidity requirement under Pillar 2 according to the Supervision Act

The CRD gives supervisory authorities in the EU the right to decide, within the scope of Pillar 2, whether a bank shall have an additional own funds requirement or liquidity requirement. Pillar 2 is the umbrella term for the rules that govern banks' internal processes for evaluating the need for both capital and liquidity and how FI conducts its risk assessments within SREP. The provisions regarding additional own funds and liquidity requirements have been implemented in Sweden through Chapter 2 of the Credit Institutions and Securities Companies (Special Supervision) Act (2014:968) (the Supervision Act).

FI has had an established process for determining banks' Pillar 2 capital requirements since 2014, and the banks are familiar with this process.[12] The process for determining an additional liquidity requirement is the same in all material respects. According to Chapter 2, section 2 of the Supervision Act, FI shall decide on an additional liquidity requirement if necessary to cover the liquidity risks that a bank is or might be exposed to and to counteract the risks to which the bank is exposing the financial system. An additional liquidity requirement is always bank-specific, and it is preceded by a risk assessment conducted by FI within the scope of a SREP.[13]

As a rule, FI does not make decisions concerning an additional liquidity requirement but informs instead each individual bank of the results of the assessment in

[10] At the same time, in January 2013, the Basel Committee published a revised version of its guidelines for calculating LCR, which changed some of the weights in the calculation and allowed the inclusion of more types of liquid assets in the liquidity buffer, assuming that these were accepted by the national supervisory authorities.
[11] The CRR states that member states had the potential to apply a liquidity coverage requirement of up to 100 per cent for banks in accordance with national legislation until a binding minimum standard of 100 per cent was fully implemented on 1 January 2018. See the decision memorandum (in Swedish) regarding the repeal on FI's website: http://www.fi.se/sv/vara-register/sok-fffs/2017/201719/ or http://www.fi.se/sv/vara-register/sok-fffs/2017/201720/.
[12] *Kapitalkrav för svenska banker*, 2014-09-08, FI Ref. 14-6258. A translation is available at www.fi.se.
[13] Chapter 2, section 2 of the Supervision Act implements Article 105 of the CRD that refers to Article 97 of the same directive, which FI, pursuant to section 9 of the Special Supervision and Capital Buffers Ordinance (2014:993), is obligated to apply in its supervision.

accordance with the SREP.[14] This procedure corresponds to the process FI applies for additional own funds requirements.

2.2 Additional liquidity requirement under Pillar 2 according to the LCR Regulation

Article 8(6) of the LCR Regulation lays down a general requirement that the credit institutions must ensure that the currency denomination of their liquidity assets is consistent with the currency distribution of their net liquidity outflows. If there is a mismatch in the relationship between the currency denomination of the liquidity buffer and the net outflows in individual currencies, FI can require a bank to restrict the currency mismatch by setting limits on the share of the liquid assets in one currency that a bank can include to cover the liquidity outflows in another currency. This restriction may be applied to the bank's reporting currency and to the bank's significant currencies, i.e. currencies that constitute at least five per cent of the bank's total liabilities[15].

If FI chooses to implement such restrictions, the LCR Regulation considers this to constitute an additional liquidity requirement within Pillar 2.

2.3 Additional diversification requirement according to the LCR Regulation

Article 8(1) of the LCR Regulation lays down a requirement that the composition of the holdings of liquid assets comprising the liquidity buffer shall remain appropriately diversified at all times. This provision thus entails a requirement on diversification between various categories of liquid assets and within each category of liquid assets, for example between various issuers, counterparties or geographic locations.

In this memorandum, FI states its view on the implications of this requirement and how that authority will be applying the requirement in its supervision.

2.4 Overview of FI's considerations and process

FI's ambition is to largely standardise and publish the supervision methods used under Pillar 2 for both capital and liquidity. In the legislative history of the Pillar 2 requirement[16], the Swedish Government also emphasises the importance of a transparent Pillar 2 process. FI can ensure the principle of equal

---

[14] In accordance with point 9(2) of Guidelines for common procedures and methodologies for the supervisory review and evaluation process (SREP), EBA/GL/2014/13.

[15] The term *significant currency* denotes a currency that the bank has to report separately in its liquidity reporting pursuant to Article 415(2)(a) of the CRR.

[16] Govt Bill 2013/14:228, p. 229.

treatment by developing methods and a general assessment practice for different types of risk. Section 3 of the Special Supervision and Capital Buffers Ordinance[17] states that FI shall provide on its website the general criteria and methods that are applied to the SREP.

2.5 Preparation of the matter and date of introduction

FI submitted a memorandum for consultation during the period 5 March 2019 to 10 April 2019 that contained a proposal for further developments to the method used in the liquidity assessment within the scope of SREP. The responses from the consultation bodies are presented in the sections of this decision memorandum where FI describes the basis it used to decide on a method for the liquidity assessment.

Compared to the consultation memorandum, FI has made a number of clarifications in this decision memorandum with respect to the format and application of the Pillar 2 requirement and FI's view of on requirement for diversification of the liquidity buffer with the aim of answering questions received from the responses from the consultation bodies.

FI intends to apply the Pillar 2 requirement as regards the LCR in all individual significant currencies (further information in section 3.1) beginning on 1 October 2019.

FI's interpretation of the implications of the LCR Regulation's diversification requirement (further information in section 3.2) will be used in supervision activities as of 1 October 2019.

[17] Special Supervision and Capital Buffers Ordinance (2014:993).

3 Liquidity coverage and diversification

3.1 Pillar 2 requirements for liquidity coverage ratio in significant currencies, including reporting currency

Swedish banks continue to generate a significant portion of their external funding through the money and capital markets in both Sweden and abroad. The banks are dependent on well-functioning financing markets in SEK and foreign currencies, primarily EUR and USD, and are thus exposed to short-term liquidity risks and potential disruptions to the access to liquidity in these markets. Shocks can occur in the markets' general functionality, but they can also be the result of failing confidence in an individual Swedish bank or in the Swedish banking system as a whole. FI is of the opinion that Swedish banks need to continue to maintain robust protection against short-term liquidity risks. Because Swedish banks are highly interconnected, this protection is important not only for the resilience of individual banks, but also, by extension, for the stability of the financial system.

National central banks can provide liquidity support to solvent banks, for example following market shocks, when banks do not have access to funding or are unable to convert their liquidity buffers to cash and cash equivalents to cover outflows of liquidity. However, an expectation that the government will provide liquidity support can create problems if this support leads to banks taking on excessive liquidity risks. FI is of the opinion that banks' liquidity coverage must be sufficient enough to withstand temporary liquidity shocks, independent of the availability of liquidity support from the central bank in a specific currency.

FI's basic premise is therefore that a bank's liquidity coverage should reflect the risks to which the bank might be exposed. The purpose of the requirement for liquidity coverage is to ensure that a bank has the resilience to withstand short-term liquidity stress in all its significant currencies. If banks have good liquidity coverage, this also means that they have assets that central banks are able to accept as collateral for loans if and when central banks provide liquidity support, regardless of whether this is provided to an individual bank or in the form of general support in a more general financial crisis.

3.1.1 FI's position

Since 2018, FI has required under Pillar 2 that banks in Supervision Categories 1 and 2[18] have a liquidity coverage ratio in EUR and USD that, for each currency, amounts to at least 100 per cent, if the currency is significant for the bank in question.

[18] See *Finansinspektionens kategorisering av kreditinstitut för den löpande tillsynen och användningen av tillsynsmetoder*, 2018-10-19 FI Ref. 18-15904 (in Swedish only). https://www.fi.se/contentassets/2839e794d0b94614a2adf9e1e51b7714/tillsynskategorisering-svenska-kreditinstitut-2019.pdf

Starting on 1 October 2019, FI will also impose a Pillar 2 requirement for every other individual currency, including SEK, provided that the currency is significant for the bank in question. The liquidity coverage ratio for each individual currency (excluding EUR and USD) must amount to at least 75 per cent. The liquidity coverage ratio is to be calculated in accordance with the LCR Regulation.[19]

The Pillar 2 requirement applies to the consolidated situation in affected banks. If there is no consolidated situation, the requirement applies at an individual level.

Banks have to comply with the Pillar 2 requirement every day. However, as with the Pillar 1 requirement for the liquidity coverage ratio[20], banks are permitted to fall below the requirement during periods of stress in order to cover unexpected cash outflows.

3.1.2 Comments received regarding FI's position

Avanza, Svenska Bankföreningen (the Swedish Bankers' Association), Finansbolagens förening (the Association of Swedish Finance Houses), Kommuninvest, Riksgälden (the Swedish National Debt Office), Riksbanken (the Riksbank), Sparbankernas Riksförbund (the Swedish Savings Banks Association), Skandinaviska Enskilda Banken (SEB) and Svenskt Näringsliv (the Confederation of Swedish Enterprise) submitted responses to all or parts of the requirement and its set-up. Fondbolagens förening (Swedish Investment Fund Association) and Konkurrensverket (Swedish Competition Authority), which were invited to participate in the consultation, have no comments on FI's proposal. The comments from the consultation bodies are described below, broken down by subject areas.

Justification for the LCR level of 75 per cent in SEK
The Riksbank believes that the proposal is an important step to strengthen Swedish banks' resilience against liquidity risks. The Riksbank has noted that some banks have had at times very low LCR levels in some significant currencies. The Riksbank believes it is important that banks take primary responsibility for the management of their liquidity risks and that the regulatory framework is set up to ensure this. The Riksbank stresses that the supply of liquidity to banks where the Riksbank acts as a lender in the event of a crisis should only be regarded as a measure of last resort.

[19] This means that the LCR in all significant currencies has to be calculated exactly as it is today in accordance with what is specified in the LCR Regulation, including Article 17 on the composition of the liquidity buffer and Article 33 on the cap on inflows.
[20] Pursuant to Article 4(3) of the LCR Regulation.

The Riksbank maintains that the argument in the consultation memorandum that liquid assets in EUR and USD may be used to cover outflows in other currencies such as SEK creates a dependence on a well-functioning currency swap market and individual institutions having access to this market. The Riksbank points out that, since it is not possible to count on these conditions always being fulfilled during a crisis, the requirement should not be set at a level that is lower in SEK than it is in EUR and USD. The Riksbank states its view that the basic premise should be an LCR requirement of 100 per cent for all significant currencies, provided there are no special reasons for another level.

SEB expresses its concern that the proposed requirement could lead to a need for certain contracts to be extended within some service segments in order to avoid large outflows within 30 days – especially currency hedging services for life insurance companies and state pension funds. SEB maintains that this may be difficult as some of the larger participants in the Swedish forward market are not subject to the new requirements.

The Swedish Bankers' Association does not think that FI is being clear in the consultation memorandum when the authority states its assessment that a bank is able to comply with an LCR requirement of 75 per cent without undesirable side effects. The Swedish Bankers' Association points out that supervisory authorities in other countries set a lower LCR requirement in their domestic currency. For example, Norway has introduced an LCR requirement of 50 per cent in NOK for banks that have EUR and USD as significant currencies. SEB and several other consultation bodies argue that a requirement of 75 per cent is high taking into account the limited supply of high-quality liquid assets in SEK.

The Swedish National Debt Office is of the opinion that there is a risk that the proposal will weaken the resilience of the Swedish banking system if the banks reduce their liquid assets in EUR and USD in favour of assets in SEK. They call for a more detailed impact analysis on liquidity risks in EUR and USD in light of the fact that requirements are also being introduced in other currencies, including SEK.

The Swedish Bankers' Association shares the view expressed by FI in the consultation memorandum, namely that banks have to be able to handle liquidity shocks on their own without relying on support from central banks. However, the Swedish Bankers' Association argues that a market situation in which a bank's liquidity management is impaired by the fact that it is not possible to convert from the major currencies to, for example, SEK is so extreme that the Riksbank should be able to provide loans to the bank in return for collateral. In light of this, the Swedish Bankers' Association does not share FI's opinion that a minimum level of liquid assets must be required in every currency in order to prevent individual banks from becoming too dependent on having the ability in all situations to cover a liquidity shortfall in one currency with a surplus in another. The Swedish National Debt Office maintains that it would be relatively simple for the Riksbank to supply the banking system with SEK if this were to be needed.

Supply of high-quality liquid assets in SEK
Several of the consultation bodies express a concern regarding the access to high-quality liquid assets in SEK. The Swedish Bankers' Association points out that the market for Swedish government debt is limited and that the supply will remain small in future. The Swedish Bankers' Association argues that it is not possible to expect Riksbank certificates to replace government debt in this respect. The Swedish Bankers' Association maintains that these certificates exist to the extent they currently do is an effect of extraordinary and temporary measures. Furthermore, the Swedish Bankers' Association is of the opinion that there is an issue with the auction procedures for the Riksbank certificates due to the uncertainty of the liquidity in these instruments. SEB points out that Swedish banks' liquid assets in SEK will need to consist largely of Riksbank certificates or overnight (o/n) deposits with the Riksbank due to the limited access to government debt. SEB is of the opinion that Swedish banks have limited opportunities to adjust their liquid assets in SEK to the same interest rate as Riksbank certificates when the certificates are fully subscribed. The bank also requests clarification from FI on whether deposits with the Swedish National Debt Office can be regarded as high-quality liquid assets when calculating the LCR.

The Swedish National Debt Office calls for an analysis of the impact on the Swedish government debt market of introducing a liquidity coverage ratio requirement in SEK.

The Swedish Bankers' Association believes that FI's proposal on LCR in significant currencies leads to a situation where the banks in the future will hold liquid assets in relatively small currencies that in a crisis are illiquid at the expense of their liquidity position in the major global reserve currencies.

The Riksbank points out that a bank is able to increase its liquidity coverage ratio without changing the composition of the liquidity buffer by extending the maturity of its funding.

Competition
The Swedish Bankers' Association rejects FI's proposal and asserts that the requirement deviates from the common application within the EU and risks impairing the competitiveness in the European market and of the Swedish banks that are subject to the requirement.

Significant currency and reporting
SEB is of the opinion that FI should clarify what the term "significant currency" means and clarify how the proposed requirement relates to the reporting requirement and whether the reporting currency is also subject to the requirement of 75 per cent. *The Swedish Bankers' Association* requests clarification of

whether it will be possible to follow up on the requirement within the scope of existing reporting or if there is a need for additional reporting.

Other regulatory interpretations and deviation from the LCR Regulation
SEB argues that Article 8(6) of the LCR Regulation provides a supervisory authority with the scope to limit currency mismatches in several ways other than by introducing an LCR requirement.

The Swedish Bankers' Association and *SEB* are of the opinion that FI can and should modify the calculation of the LCR in individual currencies if the authority chooses to introduce an LCR requirement in all significant currencies. Specific reference is made here to the provisions in Articles 33(3) and 33(5) of the LCR Regulation, where supervisory authorities can grant exemptions to the 75 per cent inflow cap. SEB interprets Article 8(6) of the LCR Regulation such that it could allow FI to introduce LCR requirements for individual significant currencies without placing any restriction on inflows. SEB also proposes that FI permit derogations from the LCR requirement on some days because liquidity movements in SEK are difficult to predict and manage in advance.

Legal basis
The Association of Swedish Finance Houses and *the Swedish Savings Banks Association* rejects the proposal since they consider the proposal to rest on an insufficient legal basis. Both consultation bodies maintain that FI should issue regulations instead of publishing a methodology memorandum without direct legal consequences since the proposal entails normative, binding requirements for the bank. For reasons of legal certainty, the consultation bodies are of the opinion that FI should be directed to use regulations to introduce binding rules. If it does not have the power to do so, FI should take action to ensure that it gains this regulatory mandate.

The Riksbank recommends that FI – contrary to how the authority normally proceeds with setting Pillar 2 requirements – should make formal Pillar 2 decisions within the liquidity regulation in order to create transparency into the affected banks and reduce the risk of legal disputes. The Riksbank believes it is important to know how the banks respond to the liquidity coverage ratio requirement and also argues that it is important for FI to ensure transparency with regard to the banks' liquidity risks. *The Swedish National Debt Office* is of the opinion that banks' compliance with Pillar 2 requirements should be publicly reported on a regular basis.

3.1.3 Reasons for FI's position

The general matching requirement in the LCR Regulation does not allow the banks to have liquidity deficits in an individual currency that are too large, even if there is a surplus in another currency that more than covers the shortfall. The justification for this requirement is that it is important to avoid an individual bank from becoming too dependent on always being able to quickly convert assets in a certain currency to liquidity and, after currency exchange, cover a liquidity shortfall in another currency. It is FI's view that the larger Swedish banks need to maintain resilience to liquidity risks in individual currencies by having sufficient liquidity buffers in the currencies that are of particular importance to the bank in question. To ensure this resilience, a certain minimum requirement level of LCR should be set in the relevant currencies. That is why FI is introducing an LCR requirement in all significant currencies, including SEK, pursuant to Article 8(6) of the LCR Regulation.

It is especially important for a Swedish bank to have a high share of liquid assets in the major currencies EUR and USD in its total liquidity buffer, provided that this does not result in the bank having liquidity reserves in its other significant currencies that are too low. EUR and USD together constitute approximately one-half of the combined net cash flows for banks that belong to Supervision Categories 1 and 2, SEK accounts for just under one-half, and other significant currencies account for the remaining, small, share. In a situation where a bank has liquid assets in EUR and USD that exceed the bank's net liquidity outflows in these currencies, the bank is able to realise excess assets and, after currency exchange, use them to meet its commitments in other currencies. However, FI argues that the banks should not rely on the FX market functioning in all stressed situations. Although the Riksbank is able to provide liquidity support to banks under certain circumstances, the banks should not assume that such liquidity support is available for situations for which the banks are able to prepare themselves.

When it comes to SEK, the question of banks' access to qualifying assets that may be included in the liquidity buffer is important when determining an appropriate level for the LCR requirement.[21] Even though the Riksbank's purchases of government bonds has reduced the volume of government debt that is available in SEK, FI makes the assessment that there are sufficient qualifying assets to allow the banks to comply with a liquidity coverage ratio requirement of 75 per cent. The reasons for this assessment are elaborated on below.

On the basis of the comments received from the consultation bodies, FI has made certain clarifications with respect to the requirement.

Justification of the LCR level of 75 per cent in SEK

Several responses from the consultation bodies, including *the Swedish Bankers' Association* and *the Swedish National Debt Office*, argue that FI is not clear in the consultation memorandum when it comes to setting the level of the LCR requirement in significant currencies at 75 per cent. *The Riksbank* argues that the basic premise should be an LCR requirement of 100 per cent for all significant currencies, provided there are no special reasons for another level.

Given these comments, FI would like to make the following clarifications. Under Article 8(6) of the LCR Regulation, there may not be mismatches between

[21] With qualifying assets that are attributable to level 1, as set out in Article 10 of the LCR Regulation.

the liquidity buffer's currency distribution and the net cash outflows per currency. The regulation does not contain any guidance on how the term "mismatch" is to be interpreted. FI is of the opinion that the provision is to be interpreted in such a way that the LCR requirement does not deviate too much from 100 per cent, and the authority has decided that 75 per cent is a well-balanced minimum level that complies with the requirements in the LCR Regulation. This specific level can be justified by an overall assessment of the following circumstances.

- In the LCR calculation, banks are permitted to count their cash inflows over a 30-day period, but with the restriction that the inflows may only be included up to an amount that corresponds to 75 per cent of the cash outflows over the same period. The justification for this cap is that the banks have to have a liquidity buffer that corresponds to 25 per cent of its outflows, even if the inflows and outflows match completely. This restriction is part of the basic principles in the Basel framework for the LCR and aims to ensure that a bank is not overly dependent on inflows that may possibly not occur in a stressed scenario. FI argues that the precautionary principle that underlies the cap on inflows is an important part of the framework. The assessment is that the regulatory framework does not allow the supervisory authority to exempt the cap. However, FI is aware that the cap of 75 per cent may entail significant reductions in contracted inflows for an individual bank when calculating the size of the LCR if the bank's inflows in a specific currency are large in comparison to the outflows in that currency. FI has, to a certain extent, taken this into account when setting the LCR requirement for SEK at 75 per cent.

- FI still argues that it is reasonable to assume that a bank is permitted to use excess amounts of the liquidity reserve in a specific currency (especially the major reserve currencies) in order to, when necessary and after currency exchange, cover liquidity shortfalls in another currency. Accordingly, it should be possible for a bank to convert its reserves in USD and EUR to SEK. In light of this, FI is of the opinion that it is not necessary to require an LCR level of 100 per cent in SEK. On the other hand, the banks' dependence on functional currency exchange markets should not be completely unlimited.

In certain cases, the Basel standard[22] allows net cash outflows in a domestic currency to not be completely covered by liquid assets in the same currency. One condition is that the supply of liquid assets in the domestic currency is insufficient and that a formal decision concerning this has been made.

In its response to the consultation, *SEB* points out that the Norwegian supervisory authority has set the LCR requirement in the domestic currency at a lower level (50 per cent) for banks that have EUR and USD as significant currencies.

[22] https://www.bis.org/publ/bcbs238.pdf, paragraph 61

FI takes the position that this lower requirement is due to NOK's position in the EU regulatory framework's technical standard as the only currency in which the availability of liquid assets is deemed to be constrained.[23] This means that the supply of liquid assets in NOK is not large enough to cover demand. Consequently, the Norwegian supervisory authority is able to set the LCR requirement significantly lower in NOK, which has also been done for some of the larger banks. Because SEK is not defined as a currency with constraints on the availability of liquid assets, FI is not able to take the same measures as the Norwegian supervisory authority.

Supply of high-quality liquid assets in SEK

In light of responses from several consultation bodies regarding the limited supply of high-quality liquid assets in SEK, FI would like to emphasise the following. The total need for liquidity buffers in SEK for Category 1 and 2 banks amounts to SEK 500–700 billion, calculated on the basis of the banks' net cash flows. The buffer varies depending on fluctuations in the net cash outflows that have to be covered. At least 30 per cent of the amount required must be covered with high-quality, liquid Level 1 assets in accordance with the LCR Regulation. The need for such assets thus amounts to SEK 150–200 billion. The banks' liquidity buffers in SEK over time have amounted to a figure somewhat smaller than the total net cash outflows, which has resulted in an average LCR for the banks as a group of around 90 per cent. This LCR value has increased recently.

In light of this, FI argues that the requirement for an LCR of 75 per cent does not mean that the banks as a group must increase their liquidity buffer in SEK. At present, all affected Category 1 and 2 institutions have an LCR in SEK that is in line with or exceeds the requirement of 75 per cent. However, the requirement means that some institutions may need to increase their contingent liquidity in SEK given their net cash outflows over certain periods.

All in all, the consultation bodies have primarily addressed in their responses the supply of Swedish government bonds. FI is aware that a need for assets of around SEK 200 billion may appear high if this requirement were to be exclusively covered by Swedish government bonds, especially in light of the fact that the entire supply of government debt constitutes SEK 743 billion, around half of which is held by the Riksbank.

The outstanding volume of Swedish government bonds is relatively small when considered in an historical perspective. This is primarily because the Swedish Government's financial position in recent years has not given rise to a larger borrowing requirement. The outstanding debt issuance in SEK is affected by several factors, among them the balance of the state budget and guidelines for

[23] https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=uriserv:OJ.L_.2015.330.01.0026.01.ENG&toc=OJ:L:2015:330:TOC

the management of central government debt. The Swedish National Debt Office's most recent forecast states that the volume of new issuance is expected to amount to around SEK 30 billion per year for 2019 and 2020.[24]

Around half of the outstanding volume of government bonds is owned by the Riksbank, which in recent years has been buying government debt for monetary policy purposes. Some of the consultation bodies stated in their responses that these government debt purchases would have reduced the volume of liquid assets available for the banks to hold in their liquidity buffers. FI argues that this is not the case. In somewhat simplified terms, the Riksbank has paid for the bonds by injecting liquidity into the banking system. This injection of liquidity is an intentional and unavoidable effect of these government debt purchases. The liquidity that the Riksbank has injected into the banking system is, in monetary terms, the same size as the volume of government debt that has been taken off the market.

The Riksbank finances its holdings of government debt by continually issuing Riksbank certificates with a tenor of one week. The certificates have an interest rate equal to the Riksbank's policy rate. Simplified somewhat, the volume of Riksbank certificates amounts to the total value of the government bonds purchased by the Riksbank. Riksbank certificates and balances in accounts at the Riksbank are counted as Level 1 assets in the LCR framework. Consequently, the total supply of liquid assets that may be included in the banks' liquidity buffers is largely unaffected by the Riksbank's bond purchases.

Some consultation bodies raised the concern in their response that the Riksbank certificates may disappear from the market if there were to be a change in the direction of monetary policy. According to these responses, it is then, if not before, a shortage of high-quality liquid assets may arise. FI shares the view that the supply of Riksbank certificates may decrease if there is a change in monetary policy, but would like to stress that it is likely that this will coincide with a reduction in the Riksbank's holdings of government debt. Such a reduction could therefore lead to an increase in the supply of government debt in the market and thus an unchanged supply of liquid assets that the banks are able to include in their liquidity buffers.

FI would also like to point out that, in addition to government debt and claims on the Riksbank, there are other asset categories that banks can include as Level 1 assets[25] in the liquidity buffer:

- covered bonds (that meet certain conditions)
- assets representing claims on:

[24] https://www.riksgalden.se/contentassets/9bb4e3c3a49c476993c46129ec16d22b/statsupplaning-prognos-och-analys-2019-2.pdf

[25] Pursuant to Article 10 of the LCR Regulation.

- local authorities (e.g. municipal bonds)
- multilateral development banks
- certain international organisations
- certain public sector entities (PSEs).

Securities for several of the asset categories in the last point are available in SEK. The volume can be estimated at a total of several hundred billion kronor.

FI would also like to make reference to the Riksbank's proposal concerning changes to the operational framework for monetary policy.[26] The proposal states that the conditions under which banks can place deposits with the Riksbank overnight will be simplified and the deposit rate will be improved.

In its response to the consultation, *the Riksbank* points out that a bank is able to increase its liquidity coverage ratio without altering the composition of its liquidity buffer by, for example, extending the maturity of its financing. FI argues that this is an accurate and important perspective on the liquidity coverage ratio. The discussions should not focus solely on the liquidity buffer, but also on how the level of the LCR as a percentage can be improved by changes to the composition of the banks' cash inflows and outflows. If net cash outflows are reduced, for example by extending the maturity of short-term borrowing, the liquidity buffer does not need to be as large.

When it comes to the question of whether claims on the Swedish National Debt Office are to be regarded as liquid assets, FI would like to clarify that each liquid asset needs to be assessed individually in order to determine whether it meets the conditions of the LCR Regulation. FI does not conduct general assessments on the basis of individual counterparties' identities.

The Swedish Bankers' Association and *the Swedish National Debt Office* argue that FI's proposal concerning the LCR in significant currencies leads to a situation where, in the future, the banks will be holding assets in relatively small currencies that are illiquid in the event of a crisis at the expense of the major global reserve currencies.

FI is of the opinion that it is unclear if and how the banks' LCR levels in EUR and USD will be affected by the fact that a requirement is now being introduced in SEK and other significant currencies in order to cover the banks' liquidity risks in such currencies. The major banks have periodically had very high LCR levels in EUR and USD. FI argues that if the banks' excess assets in these two currencies decrease somewhat going forward because of an increase in their buffers in, for example, SEK or another significant currency, this is an acceptable redistribution that allows the banks to maintain a sound level to their total contingent liquidity.

[26] https://www.riksbank.se/en-gb/press-and-published/notices-and-press-releases/press-releases/2019/riksbank-considering-changes-to-operational-framework-for-monetary-policy/

Accordingly, FI's view of the need for a liquidity buffer in the major reserve currencies has not changed. For the Swedish banks, it will continue to be important and desirable for their total contingent liquidity that they hold a high share of liquid assets in EUR and USD. FI would like to stress that the Pillar 2 requirement that banks must meet an LCR of at least 100 per cent in these two currencies still applies. No matter how desirable it may be to have large reserves in EUR and USD, it is impossible to ignore the matching requirements in the underlying regulatory framework, which, according to FI, mean that LCR cannot fall below a minimum level of 75 per cent in any significant currency.

Competition between market participants
The Swedish Bankers' Association and some other consultation bodies assert that the proposed format of FI's Pillar 2 requirements could weaken the competitive position of Swedish banks in relation to international competitors. Because of this concern, FI would like to stress that the Swedish Pillar 2 requirements on liquidity coverage ratio in individual currencies are based on Article 8(6) of the LCR Regulation, which applies to all other banks within the EU. These banks are therefore also required to comply with the general currency matching requirement pursuant to Article 8(6). This article lays down a matching requirement between different currencies on an overall level, and FI specifies the substance of this in more detail through its Pillar 2 requirements in significant currencies. A higher level of protection and resilience against unforeseen liquidity shocks may have a positive impact on Swedish banks' competitiveness by reinforcing confidence in these banks and thus contributing to lower financing costs. The adaptations the banks need to make in order to comply with the Pillar 2 requirement in significant currencies are limited in scope. Consequently, FI's assessment is that the negative impact on Swedish banks' competitiveness as a result of the liquidity regulation is marginal.

Significant currency and reporting
In light of the comments from the consultation bodies concerning significant currencies and additional reporting, FI would like to make the following clarification. The section of the memorandum concerning the legal basis states that the Pillar 2 requirements can be applied to a reporting currency or in significant currencies. A currency is significant for a bank if at least five per cent of the bank's total liabilities are expressed in the currency in accordance with Article 415(2) (a) of the Capital Requirements Regulation. FI intends to set Pillar 2 requirements in individual currencies regardless of whether it is a reporting currency or another currency if the currency amounts to at least five per cent of total liabilities.

FI's current assessment is that the liquidity regulations specified in this memorandum will not result in the authority needing to expand the banks' regular reporting. However, it is not precluded that FI may request further information going forward as part of its ongoing supervision or through an information request within the scope of the SREP.

Other regulatory interpretations and deviations from the LCR Regulation
The Swedish Bankers' Association and *SEB* are of the opinion that if FI chooses to introduce requirements on the liquidity coverage ratio in significant currencies it should modify the method for calculating the ratio in individual currencies.

However, it is FI's assessment that the regulatory framework does not allow the authority to change items, levels or other elements that appear in the Capital Requirements Regulation or the LCR Regulation in the way advocated in the comments from these consultation bodies. When it comes to the possibility of introducing a cap higher than 75 per cent of the cash inflows in accordance with Article 33 of the LCR Regulation, FI would like to clarify that *specialised credit institutions* are able to obtain exemptions following approval from the authority. A number of different conditions that are set out in the regulation must be met. Currently, no Swedish bank has this approval.

Legal basis
The Association of Swedish Finance Houses and *the Swedish Savings Banks Association* have questioned the legal basis of the proposal and argue that FI is not giving sufficient consideration to legality and legal certainty. FI has described in the memorandum *Kapitalkrav för svenska banker* the general reasons for the rules that currently govern Pillar 2.[27] Given the comments in question, it might be justified to highlight once again some of the reasons for FI's approach.

The basis for the Pillar 2 framework is the provisions regarding the SREP that are set out in the Capital Requirements Directive and that FI needs to comply with in its supervision.[28] In general, the authority needs to assess the risks that a bank is or might be exposed to and the risks that a bank may impose on the financial system. More specifically, FI must review the bank's exposure to and management of liquidity risk, including the level, composition and quality of its liquidity buffer. On the basis of this evaluation, FI has to determine, among other things, whether the bank has sufficient liquidity and, if necessary, an additional liquidity requirement is needed.

Article 103 of the directive states that if FI is able to establish that banks are or might be exposed to similar risks or constitute similar risks to the financial system, FI is able to apply the SREP to the banks in question in a similar or identical way. This encompasses, among other things, imposing additional own funds requirements or liquidity requirements on banks. In this particular case, there are more than ten banks that, on the grounds specified in this memorandum, are exposed to similar risks. Similar or identical liquidity requirements

[27] *Kapitalkrav för svenska banker*, FI Ref. 14-6258, 2014-09-08. A translation is available at www.fi.se.
[28] Section 9 of the Special Supervision of Credit Institutions and Investment Firms Ordinance (2014:993), which cites Articles 97–101 of the Capital Requirements Directive.

will be imposed on these banks unless there are special reasons for not doing so.

When FI assesses an additional liquidity requirement for a bank, this is communicated to the bank within the scope of the SREP. The reasons behind the liquidity requirement are also communicated to the bank. This memorandum increases the transparency of the process and clarifies the standardised assessment criteria for the additional liquidity requirements. The development by FI of methods and a general assessment practice for diverse risk types ensures that all banks are treated on an equal basis.

Taking into consideration primarily the need for flexibility in the event of a shock or a crisis, FI has chosen a procedure where no formal decisions are made regarding additional liquidity requirements. This means that a bank's failure to comply with the Pillar 2 requirement does not automatically trigger formal obligations by the bank to restore its liquidity as would a breach of the Pillar 1 requirement.

3.2 Diversification in accordance with the LCR Regulation

In this memorandum, FI would like to clarify its view on the appropriate diversification in the composition of the banks' liquidity buffers.

Article 8(1) of the LCR Regulation lays down operational requirements regarding the composition of the holdings of liquid assets to ensure that the liquidity buffer remain appropriately diversified at all times. The requirement applies to diversification both between the various categories of liquid assets and within the same category, for example between various issuers, counterparties or their geographic locations.

In its supervision, FI conducts analyses of how diversified the banks' liquidity buffers are. These analyses include, for example, asset categories and counterparties. FI has noted in these analyses that some banks' liquidity buffers contain a high share of covered bonds, especially banks that belong to Supervision Category 2. This share has occasionally exceeded 60 per cent of the liquidity buffers. The holdings consist primarily of covered bonds issued by Swedish issuers. With the aid of reported data, FI has also been able to conclude that the holdings of covered bonds by some banks demonstrate concentrations at the issuer level. There were also sometimes cases of cross-ownership, i.e. a bank owns covered bonds issued by another bank, which owns bonds issued by the first bank.

It is FI's viewpoint that the diversification requirement on the liquidity buffer requires a bank not to be excessively exposed to covered bonds issued by Swedish issuers when the loans in the cover pool are located in Sweden. This restriction is justified by the fact that the loans in the cover pool consist primarily of Swedish mortgages. FI's view is that the purpose of the requirement is to secure a good level of resilience in the banks' liquidity buffers even if Swedish covered bonds were to fall in value or become more difficult liquidate as a result of a disruption in the Swedish housing market, for example a sharp fall in Swedish house prices and credit losses on mortgages for the banks. The risk in covered bonds that is associated with the quality of the loans in the covered pool is particularly relevant in Sweden due to the vulnerabilities FI has identified in the form of high levels of household debt and an elevated risk of a fall in Swedish house prices.

In light of the responses received from the consultation bodies, FI has clarified its position in relation to what is set out in the consultation memorandum.

3.2.1 FI's position

For banks that belong to Supervision Category 1 and 2, FI is of the opinion that an appropriately diversified composition of the liquidity buffer does not consist of more than 50 per cent of covered bonds issued by Swedish issuers, regardless of the currency in which they are issued.

This restriction applies on the consolidated level in affected banks. If there is no consolidated level, the restriction applies at an individual level.

This is FI's interpretation of the operational requirement according to Article 8(1) of the LCR Regulation and will be used in FI's supervision starting on 1 October 2019. The Pillar 1 requirement under Article 17 of the LCR Regulation regarding the composition of the liquidity buffer in different asset categories still applies.[29]

3.2.2 Comments received regarding FI's position

Avanza, Svenska Bankföreningen (Swedish Bankers' Association), Finansbolagens förening (Association of Swedish Finance Houses), Kommuninvest, Riksbanken, Riksgälden (Swedish National Debt Office), Skandinaviska Enskilda Banken (SEB), Sparbankernas Riksförbund (Swedish Savings Banks Association) and Svenskt Näringsliv (Confederation of Swedish Enterprise) submitted responses to the consultation.

Level of 50 per cent

The Swedish Bankers' Association rejects FI's proposal and questions how reasonable it is to restrict the permitted share of covered bonds issued by Swedish issuers when FI simultaneously intends to introduce an LCR requirement in

[29] FI does not intend to change the Pillar 1 requirements regarding the total proportion of covered bonds under the LCR Regulation.

SEK of 75 per cent. The Confederation of Swedish Enterprise presents a similar argument. *Avanza* takes the approach that FI's proposal for covered bonds to only constitute 50 per cent of the liquidity buffer is in addition to the LCR Regulation, which allows covered bonds to be included up to 70 per cent of the liquidity buffer. Avanza also points out that that institutions in Categories 3 and 4 are not subject to the proposed restriction and thus will be able to hold up to 70 per cent of their liquidity buffer in covered bonds.

The Swedish National Debt Office takes the position that the restriction to the share of Swedish covered bonds in the liquidity buffer is justified. However, the Swedish National Debt Office calls for more analysis of the appropriate level and asks whether a level of 40 per cent would better safeguard financial stability. *The Riksbank* supports the proposal and argues that more pronounced requirements on diversification are beneficial to the resilience of Swedish banks and financial stability. The Riksbank is of the opinion that the restriction should also apply on a currency-by-currency basis, not just to the aggregate currency level.

The Swedish Bankers' Association's interpretation is that the proposed diversification requirement applies to the total level and not to individual currencies and calls for clarification from FI. The Swedish Bankers' Association understands FI's proposal to refer to covered bonds issued by Swedish issuers, where the loans in the cover pool are located in Sweden, irrespective of which currency the bonds are issued in.

Competition
Avanza does not view the proposal as risk-based and argues that the restriction primarily will affect credit institutions that do not have the same flexibility as large institutions in planning their liquidity buffers. *The Swedish Savings Banks Association* notes that the proposal is based on proportionality, since it targets banks where the actual risks occur.

The Swedish Bankers' Association also points out that the restriction distorts competition when compared to the conditions for foreign market participants.

Legal basis
Similarly to what was the case regarding liquidity coverage in individual currencies, the Association of Swedish Finance Houses and the Swedish Savings Banks Association questioned the legal basis of the proposal concerning diversification of the liquidity buffer and argue that FI is not taking sufficient account of legality and legal certainty.

Technical questions and enforcement of the proposal
In its response to the consultation, *the Swedish Bankers' Association* argues that it is important to have a distinct view on how the restriction of 50 per cent will apply and assumes compliance with Article 17(2) of the LCR Regulation. The Swedish Bankers' Association does not think it is clear which templates to be used in the reporting to calculate the diversification requirement and

whether they have to take into consideration repos and reverse repos in covered bonds. The Swedish Bankers' Association and several other consultation bodies are concerned that this may lead to different LCR outcomes for any given bank; one outcome for the requirement under Pillar 1 and another outcome under Pillar 2.

The Swedish Bankers' Association also believes it is unclear when the proposal will enter into force and in what way it will be considered in the ongoing SREP assessment.

3.2.3 Reasons for FI's position

In FI's repealed liquidity regulation, as in the Basel Committee's global framework for the LCR, there was a 40 per cent limitation on the maximum share of covered bonds in the liquidity buffer. The EU's LCR Regulation allows for 70 per cent of the liquidity buffer to consist of covered bonds.[30] The LCR Regulation thus allows banks to hold more covered bonds in their liquidity buffers than under the previous national regulations and the Basel standard. At the same time, Article 8(1) of the LCR Regulation contains an operational requirement on diversification of the composition of the liquidity buffer. The requirement specifies that the liquidity reserve shall be appropriately diversified, but there are no explicit quantitative restrictions. In light of the risks associated with excessively high concentration of assets, FI's interpretation of the requirement on Swedish banks is that no more than 50 per cent of the buffer may consist of covered bonds issued by Swedish issuers, irrespective of the currency in which they are issued in.

Swedish covered bonds currently have – and have had for a long time – low credit risk, which in part is expressed in their stable high credit rating from rating agencies. These bonds are bought and held by a wide spectrum of investors both in Sweden and abroad. The secondary market for Swedish covered bonds has proven itself to work well under different market conditions.

If one or more banks were to use their liquidity buffers, and there was no evident disruption in the covered bond market or the Swedish housing or mortgage market, it should not be difficult to liquidate covered bonds by selling or pledging them. All in all, these factors indicate it is possible for the banks to hold a relatively high proportion of Swedish covered bonds in their liquidity buffers.

At the same time, however, a number of the largest Swedish banks have business models that are similar, with a sizable share of mortgages. Often, these banks have a large share of market-based funding. In the event of a crisis, this kind of market structure could result in several banks experiencing difficulties at the same time. Difficulties for one bank can also spread to other banks,

[30] See the rules for calculating the composition of the liquidity buffer as set out in Article 17 of the LCR Regulation.

which in turn can affect the financial system as a whole. This systemic risk is amplified by the fact that Swedish banks hold covered bonds that are issued by other Swedish banks. This can give rise in a concentration risk, especially since there are only around ten issuers and all of them have a business focus that is reliant on mortgages.

The assets underlying the covered bonds issued by Swedish issuers are made up of a limited pool of loans consisting largely of Swedish mortgages. Even if the credit risk in the covered bonds is low, it is not possible to ignore the risk that the demand from the investors can decrease sharply if concerns were to arise regarding the quality and value of the loans. One trigger could be concerns about, or the occurrence of, a sharp fall in Swedish house prices or increased credit losses on mortgages. In summary, FI's assessment is that there may be risk associated with Swedish covered bonds, which can have a negative impact on how much liquidity these bonds can generate in a stressed situation. This risk, according to FI, should limit the percentage of banks' liquidity buffers that consist of Swedish covered bonds.

FI would like to clarify that it interprets the requirement of appropriately diversified liquidity buffers to mean that the share of Swedish covered bonds in the banks' liquidity buffers should not be greater than 50 per cent. FI's interpretation is also that the diversification requirement should limit the banks liquidity buffer so it is not too heavily exposed to individual issuers of covered bonds.

In light of the responses received in the consultation, FI has clarified certain aspects of its position and the reasons for this.

Limit of 50 per cent
FI is of the opinion that the restriction of 50 per cent under the diversification requirement applies only to the share of Swedish covered bonds in the liquidity buffer. FI would like to emphasise that the Pillar 1 requirement still applies to the composition of the liquidity buffer in terms of the different asset categories as set out in Article 17 of the LCR Regulation. The maximum share of covered bonds in Swedish banks' liquidity buffers thus remains at 70 per cent.

FI would like to respond as follows to the Riksbank's comment that the restriction should apply at the currency level and not only the total level. According to FI, the concentration risk that needs to be managed is similar, regardless of whether the Swedish issuer issues covered bonds in SEK or a foreign currency. The reason for this is that the risk is derived from the underlying assets in the cover pool, which consist predominantly of property-related assets in Sweden and primarily mortgages. Consequently, FI argues that it is more important to restrict the banks' total exposure to this asset class than to consider a limit on the currency of the issue.

By providing in this memorandum a clarification of what constitutes "appropriate diversification", FI aims to clarify the basis for its supervision. Accordingly, FI will follow up in its supervision how well the banks are complying with the diversification requirement.

Competition

Some of the consultation bodies mentioned in their responses that the requirements for diversification of the liquidity buffer may lead to competitive disadvantages for Swedish banks. On this point, FI refers to the reasoning reported in section 3.1.3. In addition to this, FI would like to clarify that the restriction on the liquidity buffer only applies to the largest Swedish banks[31], several of which are closely connected to one another and have business models with common features. The measure is thus proportional, which is also noted by the Swedish Savings Banks Association in its response to the consultation.

Legal basis

In light of the comments received regarding legality and legal certainty, FI would like to clarify in this memorandum its interpretation of the requirement for appropriate diversification. This interpretation will form the basis of FI's supervision, which means that a bank has the possibility of appealing FI decisions where the authority intervenes against a bank with reference to the requirement.

Technical questions and application of the proposal

FI would like to clarify some aspects regarding reporting and calculation.

- The same reports that are currently included in regulatory reporting will continue to apply going forward. Current templates are available at the EBA website.[32]
- When calculating the share of covered bonds issued by Swedish issuers in its liquidity buffer, the bank should also consider the current exposure, taking into account repos and reverse repos.

Several responses from the consultation bodies have expressed their apprehension that FI's proposed changes may result in different LCR outcomes for any given bank; one outcome for the requirement under Pillar 1 and another outcome under Pillar 2. FI would therefore like to clarify that assets not compliant with the operational requirements in the LCR Regulation may also not be included in the calculation of liquidity coverage in accordance with Pillar 1. Consequently, it is not possible for different LCR outcomes to arise as a result of the additional limitation imposed within the scope of the SREP.

In this context, it is important to emphasise that there is nothing to prevent a bank from having holdings of Swedish covered bonds in excess of 50 per cent

[31] In Supervision Categories 1 and 2.
[32] https://eba.europa.eu/risk-analysis-and-data/reporting-frameworks

of its liquidity buffer. However, any excess holdings must be excluded when calculating the LCR and thus reported in a separate row in the LCR report.[33]

Similarly to what is stated in section 3.1.3 of the memorandum, FI does not intend to introduce any additional regular reporting, but it cannot be precluded that the authority may request additional information as part of its supervision or in the request for information within the scope of the SREP.

The Swedish Bankers' Association response to the consultation regarding the application is commented on in section 2.5 of this memorandum.

4 Impact analysis

4.1 Impact on banks and competition in the market

Affected banks

There are currently thirteen banks that belong to Supervision Categories 1 and 2. All of these banks already report their liquidity coverage in significant currencies to FI in line with the reporting requirements in the Capital Requirements Regulation. A liquidity coverage ratio requirement for all currencies combined and for EUR and USD individually is already in place for affected banks.

Under the current proposal to expand FI's Pillar 2 requirement, more banks than are currently covered will become subject to a quantitative liquidity coverage requirement in SEK and other significant currencies (excluding EUR and USD).

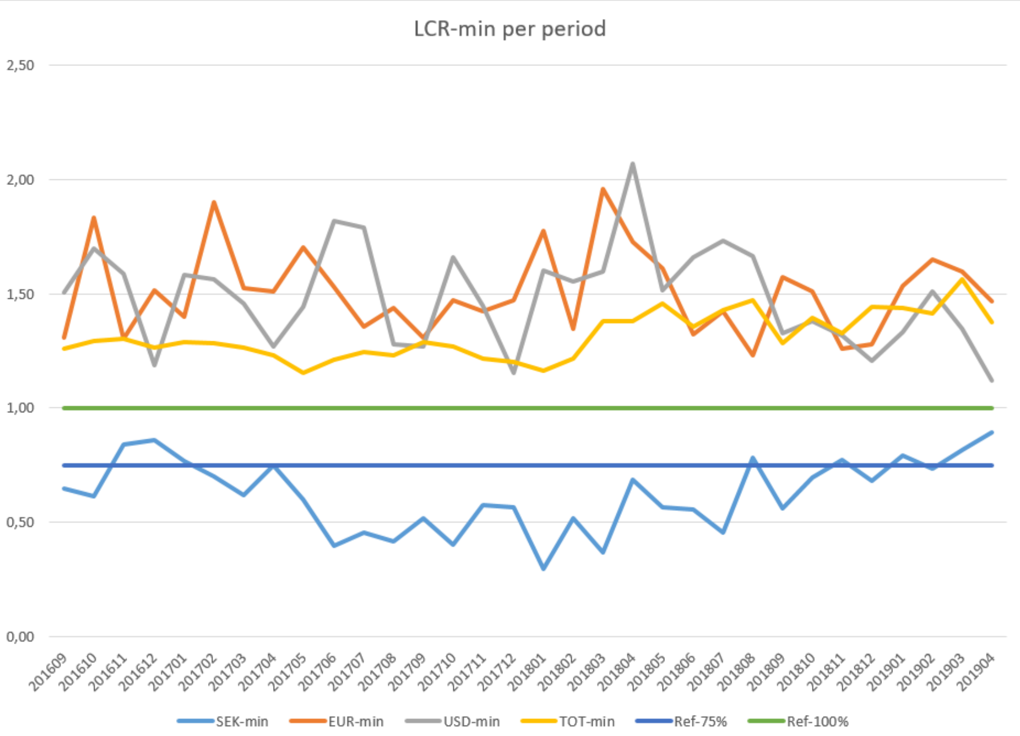
The new LCR requirement of 75 per cent in SEK will not affect the five banks that currently only have SEK as a significant currency. These banks already need to maintain an LCR level of 100 per cent in SEK since this is necessary to meet the requirement of a total level of 100 per cent. Seven banks need to comply with a new requirement for LCR in SEK.

With respect to other significant currencies, eight banks have EUR or USD or both as significant currencies. These eight banks have previously been required to comply with a Pillar 2 LCR requirement in these currencies. One bank in both Supervision Category 1 and 2 has GBP as a significant currency, one bank has NOK and DKK, and one bank has JPY. Accordingly, there are four banks that will receive a new requirement in LCR in a significant currency other than SEK, USD and EUR.

[33] Row 590, template C72 "Level 1/2A/2B assets excluded for operational reasons except for currency reasons".

From the reported data, FI has noted that the liquidity coverage ratio in EUR, USD and other foreign currencies for all of the thirteen affected banks continually exceeds 100 per cent by a good margin. The liquidity coverage ratio in SEK on average across the whole group of banks has been lower, but it has still been in excess of 75 per cent. The volatility has been large for individual banks from time to time. However, for individual banks, the liquidity coverage ratio in SEK has been at relatively low levels for long periods, but has recently risen somewhat.

The graph below shows the lowest LCR ratio measured for any of the banks in Supervision Categories 1 and 2 since the autumn of 2016.



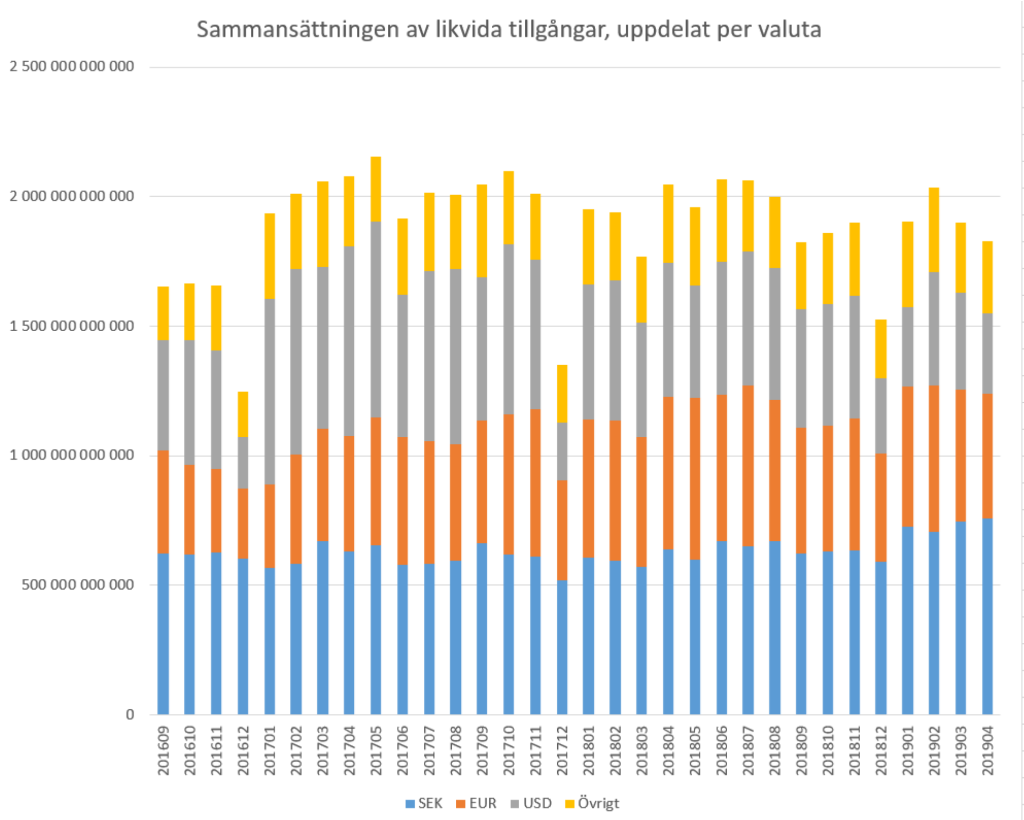
It is difficult to assess what economic effects the requirement on a specific total liquidity buffer and on parts of the buffer will have on banks. The net cost is dependent on the difference between the financing costs and the return on the assets in the liquidity buffer. To the extent that the banks will need to reallocate in order to comply with the liquidity requirement, it is reasonable to assume that they will strive to keep costs as low as possible. If a bank does not achieve a required level in an individual currency, it may, for example, extend its funding, buy more liquid assets or reallocate assets it already has into the currency where there is a shortfall in relation to the requirement. Because some Swedish banks up until now have had assets in EUR and USD in excess of the requirement of 100 per cent, it is reasonable to expect that some banks will transfer some of their excess holdings to SEK in order to comply with the new minimum requirement.

If the affected banks implement liquidity measures of this type, as things currently stand this may result in a net cost for the banks since holdings of high-quality Swedish liquid assets may provide a lower return than money market rates in EUR and USD. Because all banks are currently complying with the requirement of 75 per cent liquidity coverage in SEK, it is FI's interpretation that the banks are already taking this lower return into account in their business models.

Another aspect of a potential increase in the share of Swedish government bonds in banks' liquidity buffers is the possible effects this increase may have on the ability of the Swedish government bond market to function. FI shares the view that it is not desirable for an even larger percentage of the available government debt to be locked up in portfolios and not turned over in the market. Nonetheless, these proposed measures are deemed to be so small that the potential effect on the functioning of the market should be marginal.

FI is aware that holdings at another bank may not be included when calculating the liquidity coverage ratio and FI's requirement could therefore lead to more market participants wanting to deposit their liquidity in the short term directly at the Riksbank instead of at another bank. At present, this would entail a financial burden for the banks in the form of a lower return on their liquidity. As stated in section 3.1.3 of this memorandum, the Riksbank is currently reviewing changes to the operational framework for monetary policy, which among other things includes a simplification of the conditions for banks' overnight deposits of surplus liquidity at the Riksbank and improvements to the deposit rate.

The graph below illustrates the composition of the liquidity reserve by currency as a total for all the banks combined in Supervision Categories 1 and 2.



FI's interpretation of the diversification requirement, namely that the share of covered bonds issued by Swedish issuers should not exceed 50 per cent of the liquidity buffer, is currently being complied with by most of the banks in Supervision Categories 1 and 2. A few banks in Supervision Category 2 have holdings that exceed 50 per cent of the liquidity buffer. As previously stated in this memorandum, FI interprets the operational requirement in the LCR Regulation to mean that the excess shares of Swedish covered bonds are not to be included in the calculation of the liquidity coverage ratio. All banks that have a higher share of Swedish covered bonds in their liquidity buffer could exclude these holdings when calculating the LCR and still comply with the LCR requirement in total and in SEK. This means that the limitation of 50 per cent need not result in any changes to the banks' liquidity buffers. The effect is that the reported LCR levels for some banks become somewhat lower.

If a bank still wishes to maintain the total LCR level, it can reinvest by selling and reducing the share of Swedish covered bonds in its liquidity buffer and reinvest the liquidated means in other assets that the bank can include in the liquidity buffer. The size of the potential alternative cost will then mainly be dependent on the asset class the bank chooses instead of covered bonds.

Competition on the market
All banks in the EU and EEA are subject to the LCR Regulation and thus need to comply with the general currency matching requirement under Article 8(6) that FI's Pillar 2 requirement on the liquidity coverage ratio in individual currencies is based on. All banks are also subject to the operational requirement on

diversification in Article 8(1). Even if supervisory authorities in different countries to some extent can interpret the regulation differently, leeway is limited. FI's requirement could weaken Swedish banks' competitiveness in relation to international participants that are not subject to the LCR Regulation. At the same time, however, FI's assessment is that a higher level of protection and resilience against unforeseen shocks may also have a positive impact on Swedish banks' competitiveness by contributing to increased confidence. Consequently, it is FI's assessment that there should only be a limited effect on the competitiveness of Swedish banks within the EU as a result of the new Swedish liquidity requirement.

FI takes a fundamentally positive stance on the position that the regulatory conditions for Swedish banks should be equivalent to those that apply to banks in other EU Member States, but considers there to be justification in some cases to add additional national measures to the regulatory framework. The same opportunity is also available to other member states in the EU and EEA. Norway, Denmark and the United Kingdom are examples of countries that have LCR Pillar 2 requirements in accordance with the LCR Regulation[34]. Some of these countries also have a requirement in the domestic currency.

Given its assessment of the vulnerabilities for the Swedish banking system, FI considers it to be important to ensure that Swedish banks have good resilience to short-term liquidity risks. Since the additional requirements strengthen the resilience of individual banks to liquidity problems, the impact on the confidence in the affected individual banks and the banking system as a whole should be positive.

4.2 Impact on society and the banks' customers

The expanded liquidity requirement presented in this memorandum may change the costs of Swedish banks for their liquidity buffer due to the need to hold a certain minimum level of assets in SEK and the reallocations of liquid assets that may be required to meet the operational requirement on diversification. Because the new requirements do not entail a significant change to the current portfolio structure of the banks subject to the LCR regulation, it should be possible to assume that the additional impact of the quantitative requirements on liquidity coverage in the form of liquid assets is limited.

FI makes the assessment that consumers, firms and society at large could be positively affected by the new requirements since they aim to reduce the risk of problems in the financial system. Even if the liquidity requirements are based on the risks to which an individual bank may be exposed, liquidity problems in one bank could spread quickly to other banks and, in a worst-case scenario, turn into solvency problems if liquidity shocks cause losses by triggering events that lead to

[34] See Pillar 2 Liquidity CP13/17, 13 July 2017, Bank of England https://www.bankofengland.co.uk/prudential-regulation/publication/2016/pillar-2-liquidity and *Afgørelse om yderligere likviditetskrav for danske SIFI'er*, 21 June 2016, Finanstilsynet https://www.finanstilsynet.dk/da/Tilsyn/Tilsynsreaktioner/Afgoerelser/Afgoerelser-2016/SIFI-2016.

falling asset values. Ultimately, this is why a bank's liquidity risks are not just a risk posed to the individual bank, but rather to the financial system as a whole. FI therefore makes the assessment that these additional requirements strengthen financial stability.

5 FI's supervision work

FI focuses in this memorandum on how the authority intends to place Pillar 2 requirements on liquidity coverage in significant currencies and SEK and on how the authority views the operational requirement on diversification in the LCR requirement with regard to the composition of the liquidity buffer. It should be emphasised that supervision of the banks' liquidity and financing risks include more areas than those covered by the position in this memorandum.

The overall SREP assessments of the banks' liquidity take into account not only LCR in all significant currencies but also LCR under additional stress, the bank's liquidity-related survival horizon under various stress assumptions and the counterbalance capacity and financing profile. FI also reviews the bank's internal processes for liquidity assessment and policies, processes and procedures to measure and manage liquidity and financing risks.

5.1 Concluding remarks

FI is of the opinion that the regulation and supervision of liquidity risks need to consider and counteract the vulnerabilities that are present in the Swedish banking market. FI is clarifying its view of the liquidity regulations so as to ensure that banks have stronger resilience to short-term liquidity stress in individual currencies and their liquidity buffers. FI's assignment to conduct risk-based supervision therefore entails being proactive and carefully following market developments and any structural changes to ensure that FI's internal methods for assessing banks' liquidity and financing risks in both the short term and the long term remain relevant.