M E M O R A N D U M

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Finansinspektionen's approach to the Basel 1 floor

Summary

The new European capital requirement regulations that came into effect on 1 January 2014 contain an option for Finansinspektionen (FI) to grant banks waivers from the current so-called Basel 1 floor. However, as expressed already in the authority's initial position in December 2013, FI does not consider it to be appropriate to utilise the option to grant waivers. The feedback subsequently received has not given FI reason to alter its position.

The Basel 1 floor is a back-stop for the lowest level of the own funds requirement that was implemented in conjunction with the transition from Basel 1 to Basel 2. FI's position means that the Basel 1 floor will also apply in the future in Sweden in the same manner as it does today, in other words as 80 per cent of the capital requirement calculated in accordance with the Basel 1 regulation.

A stable financial system is a cornerstone of the entire national economy. One of the most important factors for maintaining financial stability is the banking system's capital strength. The fact that the Basel 1 floor will also continue to lock capital into the banking system is thus positive for financial stability, all else equal. It is equally important that the floor remains in place as an ultimate back-stop against future decreasing capital requirements.

The new buffer requirements in Basel 3, including the systemic risk buffers for the major Swedish banks, will be calculated without taking the floor rules into account. The Basel 1 floor only constitutes a parallel back-stop for the lowest level of own funds and therefore does not entail a deviation from the so-called November Accord regarding how much capital Swedish banks should have.

In total, the Basel 1 floor locks just shy of SEK 17 billion into the own funds of the Swedish banking system. This capital is already locked in today due to the floor and is not considered a new, additional capital requirement.

Contents

1 Introduction

This memorandum aims to describe how FI will use the authorisations given to national competent authorities by the EU's new capital requirement regulations in terms of the so-called Basel 1 floor.

FI published its initial positions in a memorandum in December 2013, and at the same time provided the parties affected with the possibility of providing feedback. In the present memorandum, FI describes its final positions and the reasons for them, and responds to the feedback received.

Within this memorandum, the term "bank" is used for all institutions covered by the regulations, even if some of them are not banks but rather credit institutions.

2 Background

2.1 Purpose of the Basel 1 floor

In 2005, the Basel Committee on Banking Supervision (the Basel Committee) published the Basel 2 agreement.[1] Under this agreement, the capital requirement was made, among other things, more risk-sensitive compared to the simpler and more standardised rules that formed the original agreement from 1988, Basel 1. This greater risk sensitivity was achieved primarily by providing the banks with the opportunity to base the capital requirement for credit risk on internal models following review and authorisation by supervisory authorities. The purpose of the changes to the regulations in Basel 2 was, in other words, to redistribute the capital in the banking system from less risky to more risky exposures. This would be achieved by providing banks with incentives to implement internal models. The idea was that an average bank would have a modest but still lower capital requirement when applying the internal models than when applying the simpler standardised approaches.

To ensure that the implementation of internal models would not result in too large of a reduction in the capital requirements, the Basel Committee implemented transition rules in the form of a back-stop for the lowest level of the total capital requirement. The transition rules, the so-called Basel 1 floor, were designed in such a manner that the capital requirement for the banks using internal models for credit risks or operational risks could never be lower than a certain per cent of the capital requirement calculated in accordance with the old Basel 1 regulations. This percentage was 95 per cent in 2007, 90 per cent in 2008 and 80 per cent as of 2009.

[1] International Convergence of Capital Measurement and Capital Standards, A Revised Framework, Updated November 2005.

In the Basel 2 agreement, the Basel Committee stated that it was prepared to leave the Basel 1 floor in place even after 2009 if there were any problems during the transition period. On 13 July 2009 the Committee announced in a press release that it had reached an agreement that the Basel 1 floor would remain in place even after 2009.

2.2 Regulation and scope of the Basel 1 floor

2.2.1 Regulation until 31 December 2013

Until 31 December 2013, the Basel 1 floor was regulated in section 5 of the Capital Adequacy and Large Exposures (Implementation) Act (2006:1372). According to the provision, banks using an internal model for credit risk or operational risk shall have own funds corresponding to at least 80 per cent of the capital requirement calculated in accordance with the Capital Adequacy and Large Exposures Act (1994:2004).

The EU directives implementing the Basel 1 agreement at the EU level were implemented in Sweden through the above-mentioned Capital Adequacy Act from 1994. The EU regulation for capital requirements was subsequently amended through the Basel 2 agreement which was implemented through two directives – the Credit Institution Directive[2] and the Capital Adequacy Directive[3]. The Swedish provision regarding the Basel 1 floor was based on the transition rules set out in Article 152 of the Credit Institution Directive. Through an amendment to the law in 2011, the application of the floor rule in Sweden was extended and the decision of how long the floor would apply was given to the Government (see Prop. 2010/11:110). The Government ordered via section 31a of Capital Adequacy and Large Exposures Ordinance (2006:1533) that the floor rules shall apply until 31 December 2013.

2.2.2 Regulation as of 1 January 2014

On 1 January 2014 new European capital requirement regulations entered into force. The regulations, which are based on the Basel 3 agreement, consist of one directive, the so-called CRD 4[4], and one regulation, the so-called CRR[5].

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[2] Directive 2006/48/EC of the European Parliament and of the Council of 14 June 2006 relating to the taking up and pursuit of the business of credit institutions (recast).

[3] Directive 2006/49/EC of the European Parliament and of the Council of 14 June 2006 on the capital adequacy of investment firms and credit institutions (recast).

[4] 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.

CRD 4 will be implemented in Sweden in 2014 via various acts and regulations. Since CRR is a regulation, it started to apply directly as law in Sweden when came into effect. Article 500 of CRR states that the previously applicable transition regulations, i.e. the Basel 1 floor, will continue to apply until 2017. Otherwise, the design of the floor has not changed in substance compared with the Credit Institution Directive.

One new provision in CRR, however, is that Article 500(5) states that the competent authority, in Sweden FI, has the right to waive the application of the Basel 1 floor by a bank provided that the bank fulfils the minimum requirements for using the internal models. The waiver option should be viewed within the context of the Basel 1 floor in CRR being a transition rule that will be repealed in 2018. Before the decision, the competent authority should consult with the European Banking Authority (EBA), but the national authority will make the final decision. In other words, according to CRR, it is up to the competent authority to decide if the Basel 1 floor should continue to be applied regarding an individual bank.

2.2.3 Scope

The banks or bank groups using an internal model for credit risk or operational risk[6], and thus are subject to the Basel 1 floor, are Handelsbanken, Landshypotek, Länsförsäkringar Bank, Nordea, SBAB, SEB, Svensk Exportkredit, Swedbank and Volvo Finans. Six savings banks are also subject to the floor: Bergslagens, Färs & Frosta, Rekarne, Sjuhärad, Vimmerby and Ölands.[7]

The floor applies to both the consolidated level, i.e. for the financial group, and individually for the companies that belong to the group, provided that these companies have received authorisation to use an internal model.

2.3 Legal regulation of the Basel 1 floor

Article 500 of CRR states that an institution’s own funds must as a minimum amount to the higher either of 8 per cent of the risk-weighted assets calculated using the new regulations (minimum capital requirement in accordance with Article 92 of CRR) or the Basel 1 floor capital requirement. If the floor entails a higher capital requirement than the minimum capital requirement under

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[5] 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.

[6] Only SEB uses an internal model for operational risk. SEB also uses an internal model for credit risk.

[7] All of these banks 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.

Article 92, this is the amount that constitutes the minimum level for the institution's own funds. If an institution does not maintain this minimum level for its own funds, FI shall intervene in accordance with Chapter 15 of the Banking and Financing Business Act (2004:297).

This means that if a bank falls below the minimum level of own funds as per the Basel 1 floor, the legal consequences are the same as if the bank falls below the minimum capital requirement as per the main rule in Article 92. The Basel 1 floor should therefore be considered to be an absolute minimum capital requirement.

3 FI's approach to the waiver option

3.1 FI's position

FI does not believe it is appropriate to utilise the option provided by CRR to waive the application of the Basel 1 floor. It thus follows that FI neither finds scope to grant a bank such a waiver.

3.2 Feedback received

The Riksbank welcomes FI's intention not to grant waivers from the Basel 1 floor, and finds that the floor constitutes an appropriate complement to the other capital requirements that banks must meet. According to the Riksbank, FI's position contributes to confidence in the Swedish banking system and assists in increasing the resilience of Swedish banks to financial stress.

The Swedish Bankers' Association firmly opposes the view that the Basel 1 floor should continue to apply for Swedish banks. Because Sweden has chosen to fully apply the new requirements of the Basel 3 agreement immediately when the rules come into effect, it is highly logical to also refrain from applying the floor rules from this point in time. The Swedish Bankers' Association also believes that the funding possibilities of banks would deteriorate rather than strengthen if the Basel 1 floor were maintained. This is because investors and financiers to an equal extent look at the gap between the level of a bank's own funds and the minimum capital requirement, and the actual level of own funds, and a maintained Basel 1 floor leads to a general narrowing of this gap. Furthermore, the Association objects to the statement that the banks' purpose for using internal models is as a means of reducing the capital requirement rather than achieving sound, sophisticated risk measurement. The internal models used by the banks are very useful for capturing and measuring the risk in different types of operations. By developing and applying such models, which moreover have been approved by FI, the banks have improved their risk management and been able to develop risk-based pricing.

SBAB Bank AB concurs with the viewpoints of the Swedish Bankers' Association.

Landshypotek agrees with FI that a high a share of own funds in relation to risk is important for maintaining confidence in the banks. However, Landshypotek should be granted a waiver because it is questionable whether the capital requirement for a low-risk bank such as Landshypotek should need to be as high as is set out by the Basel 1 floor.

The Association of Swedish Finance Houses has no objections to the proposal**.**

3.3 Reasons for FI's position

The Basel Committee, of which FI is a member, has decided that the Basel 1 floor will apply until further notice. FI therefore finds, despite the objection of the Swedish Bankers' Association, that the floor rules should not be viewed as a temporary or transitional part of the international agreement regarding the capital adequacy regulations. As expressed in section 2.1, the purpose of the Basel 1 floor was to ensure that the introduction of internal models would not lead to too high a reduction in capital requirements. There was thus no connection between the floor and the implementation of the Basel 3 agreement.

Furthermore, FI can ascertain that the discussions regarding the reliability of internal models has intensified on the international arena. Both the Basel Committee and EBA have recently published reports discussing the problem of comparability between the banks' model-based risk weights.[8] FI's opinion is that the Swedish banks' relatively low model-based risk weights in general can be explained by the banks' low credit loss history. Model risk is one of the areas that FI focuses on in its supervision and FI has, for example, highlighted it as one of the risks in its most recent Risk Report.[9]

FI perceives there to be signs that the banks' primary purpose for using internal models is changing from achieving a sound, sophisticated risk measurement to being a means to be able to decrease the capital requirement. This is due to a problematic incentive structure in which the banks' management is being pressured by the stock market to minimise the risk-weighted assets in order to increase the funds available for dividends. Add to the mix that there are significant opportunities for the banks to influence risk weight levels in internal models themselves, and there are grounds for FI to carefully monitor what is

[8] EBA second interim report on the consistency of risk-weighted assets in the banking book of EU banks from August 2013, EBA interim report on the consistency of risk-weighted assets in the banking book from February 2013, BCBS's Analysis of risk-weighted assets in the trading book from January 2013 and BCBS's Analysis of risk-weighted assets in the banking book from July 2013.

[9] Risks in the financial system 2013. Published on fi.se on 14 November 2013.

happening. By this, FI does not mean that the sole purpose of banks in using internal models is to reduce the capital requirement. On the contrary, FI finds, like the Swedish Bankers Association, that use of the models has led to many improvements in the risk management of banks. The Swedish banks that are authorised by FI to use internal models for capital adequacy purposes also essentially comply with the requirements placed by the regulations on the models. Nonetheless, FI cannot disregard the uncertainties associated with the reliability of the models, both in Sweden and internationally. Indeed, it was the risk of too great a reduction in capital requirements that motivated the Basel 1 floor when the internal models were introduced. FI therefore finds that it would be a hasty decision to remove the Basel 1 floor before the international standard-setting bodies, in this case primarily the Basel Committee, have developed proposals for how problems associated with the internal models should best be handled.

The Basel Committee has started an extensive project to investigate and address the problems associated with internal models. Among the planned measures that are being discussed are improved transparency, additional guidelines regarding or specification of the requirements on internal models and potential floors for individual risk parameters in the internal models.[10] In a memorandum from July 2013, the Basel Committee mentions examples of more, and even more powerful, measures that could be relevant to reduce the variability in the model-based risk weights.[11] From these measures, one should be mentioned in particular – the idea of a new permanent floor for the banks' capital requirement, which would be designed as part of the capital requirement according to the standardised approaches in Basel 3.

The measures that are being discussed within the Basel Committee are still in the planning stage, but FI still believes that it is probable that the Committee will implement hard-hitting measures against the problems with internal models in the coming years. Since the model-based risk weights of the Swedish banks are low in international comparison,[12] the Committee's future measures could result in a noticeable increase in the capital requirement for the Swedish banks. If FI were to waive the application of the Basel 1 floor now, this would mean that the banks would be more poorly prepared for adapting to future changes in the Basel Committee's capital adequacy regulations. This in and of itself presents grounds for leaving the Basel 1 floor in place until further notice,

[10] See Global consistency in financial regulation: is the glass half full, half empty, or just more transparent? Remarks by Wayne Byres, Secretary General, Basel Committee on Banking Supervision, at the RiskMinds Risk and Regulation Forum, Nice, France, 10 September 2013

[11] Discussion paper. The regulatory framework: balancing risk sensitivity, simplicity and comparability. July 2013.

[12] See Report 2006:6, Banks' capital requirements under Basel 2, Finansinspektionen, June 2006 and Risk weight floor for Swedish mortgages, Finansinspektionen, May 2013.

since it is reasonable to believe that such future changes will also result in changes to the EU's capital adequacy regulations.[13]

A stable financial system is a cornerstone of the entire national economy. One of the most important factors for maintaining financial stability is the banking system's capital strength. The fact that the Basel 1 floor will also continue to lock capital into the banking system is thus positive for financial stability, all else equal. It is equally important that the floor remains in place as an ultimate back-stop against future decreasing capital requirements.

In order to maintain confidence in the Swedish banking system's capital strength, it is very important that the Swedish implementation of the capital adequacy regulations is perceived as robust and sufficiently conservative. FI is not aware of any Member State within the EU that has announced that it intends to grant waivers from the Basel 1 floor. If Sweden were to diverge with a significantly less cautious application of the capital adequacy regulations with regard to this point, this could damage confidence in the Swedish banking system as a whole. Reduced confidence could ultimately have a negative impact on financial stability and hence too on the funding possibilities of Swedish banks. Thus, this also indicates that the banks should continue to apply the Basel 1 floor. By reason of the objection of the Swedish Bankers' Association to the view that the funding possibilities of banks would deteriorate if the Basel 1 floor is maintained, FI wishes to point out that the opinion suggesting that maintaining the floor ought to be positive for the funding possibilities of Swedish banks at large is not based on the capital effect for individual banks, but on how the robustness of the Swedish banking system is perceived on the whole, which also includes regulation and supervision.

3.4 FI's position in relation to the November Accord

3.4.1 Feedback received

The Swedish Bankers' Association points out that FI's position on the Basel 1 floor was surprising at this late stage of implementation of the rules. The statement about a substantial part of the so-called November Accord – as it is perceived by banks and other stakeholders – being contravened risks undermining confidence in the stability and predictability of the Swedish regulations.

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[13] The Basel Committee's agreements do not have any formal legal status in Sweden. However, previous experience has shown that the EU normally opts to transform the Basel agreements on capital adequacy requirements into EU legislation. The Basel Committee monitors Member States' implementation of the Basel agreement, see http://www.bis.org/bcbs/implementation/l2.htm

3.4.2 Background and FI's opinion

In November 2011, FI, the Swedish Ministry of Finance and the Riksbank announced in a press release that Swedish systemically important banks would be subject to a capital buffer for systemic risk of 3 per cent as of 2013 and 5 per cent as of 2015 (the so-called November Accord).[14] The press release also specified that the requirement would as a minimum apply to the four major Swedish banks, i.e. Handelsbanken, Nordea, SEB and Swedbank, and that the requirement would be placed at group level. Furthermore, it was stated that the new, higher capital requirements were fully based on the new capital adequacy regulations, Basel 3, i.e. without floor rules.

As the Basel 1 floor is implemented in Sweden, and as it will also be applied after 1 January 2014 as per FI's position, the floor is calculated in parallel to the calculation of the total capital requirement in accordance with the Swedish and European implementation of the Basel 3 agreement. This means that the new buffer requirements are calculated without taking the floor rules into consideration (see also section 5). Leaving the Basel 1 floor in place untouched is therefore not in conflict with the November Accord. The floor functions instead – completely in line with its original purpose – as a back-stop to protect the total capital requirement from being too low.

The Swedish Bankers' Association has expressed that confidence in the stability and predictability of the Swedish regulations is threatened by FI's position of not granting waivers from the Basel 1 floor. As described above, FI finds that maintaining the floor does not conflict with the November Accord. Furthermore, confidence in the financial regulatory framework does not just depend on its stability, but also on the ability to adapt it to changed circumstances – in this case mainly the intensifying questioning, both nationally and internationally, of the internal models described in section 3.2.

4 Authorisation for floor calculation based on the standardised approach

4.1 FI's position

FI does not consider it appropriate for a bank to use the provision of Article 500(2) of CRR. There is hence no scope to entitle a bank to base its calculation of the floor on the standardised approach instead of the Basel 1 regulations, even if the bank fulfils the regulation's other conditions to do so.

[14] See the press release from 25 November 2011; New capital requirements for Swedish banks, on www.fi.se

4.2 About the regulation and its purpose

Article 500(2) and (500.3) of CRR state that banks that started to use an internal model on 1 January 2010 or later may calculate the floor based on the standardised approach set out in CRR instead of the Basel 1 regulation. However, this is conditional upon the approval of the competent authority, in Sweden's case FI.

The reason as to why banks that started to apply an internal model after 1 January 2010 may be eligible to use a different reference point for the calculation of the floor is that the European legislator has made the assessment that it could be much too administratively burdensome for banks which have adapted their systems for capital adequacy calculations to the standardised approach (and thus do not still have their old systems for calculating the capital requirement in accordance with the Basel 1 regulations) to need to adapt or build new systems to calculate the floor.

4.3 Reasons for FI's position

There is currently only one small Swedish bank that meets the conditions of the regulation, i.e. that the bank started to apply an internal model on 1 January 2010 or later, and thereby could be eligible to apply the special calculation that is prescribed. Other banks that use internal models today started to apply these models at an earlier date. However, it may become relevant in the future for FI to grant authorisation for the use of internal models to new banks. In such a case, the matter of potential consent according to Article 500(2) may also arise once again.

The standardised approach on average results in a lower capital requirement than the Basel 1 regulations.[15] This is due to, among other things, more advantageous risk weights for lending to private individuals and small firms and for loans collateralised by residential properties. Being allowed to base the floor calculation on the standardised approach could therefore constitute a competitive advantage for the banks that in the future start to apply an internal model compared to those that already do so today.

Applying the regulations differently for firms that are of the same type and are active on the same market would need to be particularly well-motivated to be able to compensate for the competitive imbalances that could arise. FI does not believe that the noticeable, but still limited, administrative burden involved in adapting systems for capital requirement calculation to the Basel 1 regulations is sufficient grounds for allowing significant competitive advantages. In this case it should also be taken into consideration that particularly high requirements are placed on a bank's risk measurement ability in order for it to

[15] Results of the fifth quantitative impact study, The Basel Committee, June 2006.

be granted authorisation to apply an internal model. FI believes that it is not unduly burdensome for a bank in such a situation to further adapt its systems to also be able to conduct a capital requirement calculation in accordance with the – in this context – simple Basel 1 regulations.

5 Calculation of the Basel 1 floor

5.1 Calculation of the capital requirements as per the floor rule

As the Basel 1 floor is expressed in CRR, it consists of – as in the Swedish legislation until 31 December 2013– a requirement that own funds shall be a certain minimum amount in SEK (or in another accounting currency). It does not place any formal requirement on a certain capital adequacy ratio and does not serve as a floor for the risk-weighted assets.

The capital requirement as per the Basel 1 regulations is 8 per cent of the risk-weighted assets calculated using the same regulations. The lowest level of own funds in accordance with the floor rule is thus 80 per cent of this amount.

5.2 Calculation of the risk-weighted assets

5.2.1 Background and FI's opinion

Until 1 January 2014, application of the Basel 1 floor in Sweden followed from the Capital Adequacy and Large Exposures Act – the law through which Basel 1 was implemented in Sweden. On 1 January 2014, CRR came into effect. The EU regulations are in direct effect in all Member States and hence apply as law in Sweden. Article 500 of CRR, which regulates the Basel 1 floor, refers to the EU Directive implementing Basel 1, i.e. Directive 93/6/EEC and 2000/12/EC in their wording prior to 1 January 2007 (so-called Basel 1 Directives).

In addition to the fact that the Basel 1 Directives were minimum directives and allowed for more stringent national application, they also contained some express possibilities for national options. Of particular interest in that context is the fact that Article 62 of Directive 2000/12/EC gave Member States the possibility of allowing loans collateralised by commercial property to be risk-weighted at 50 per cent, provided that the credit exposure fulfilled certain terms stipulated in the directive.

FI is of the view that the capital requirement according to the floor rules should also continue to be calculated in accordance with the Swedish implementation of the Basel 1 Directives. Since the regulation of the floor is not changed in substance through CRR, compared to the current Credit Institution Directive, it is clear that there is no intention from the European legislator for there to be any change in this respect through the entry into force of CRR. This means, for example that loans collateralised by commercial properties will be risk-weighted at 100 per cent also in the future, in accordance with the Capital Adequacy and Large Exposures Act and related regulations.

5.2.2 Feedback received and FI's assessment thereof

The Swedish Bankers' Association expresses the following. In the Basel 1 regulations, lending for tenant-owned apartments had a risk weight of 100 per cent. A consequence of the application of the Basel 1 floor is that the actual risk weight for tenant-owned apartments is 80 per cent, which is the same as for an entirely unsecured retail loan, and twice the risk weight for single-family dwellings. According to both Basel 2 and Basel 3, lending for tenant-owned apartments is at parity with lending for single-family dwellings, with a risk weight of 35 per cent according to the standardised approach. A continued and such substantial difference in risk weights for credits with relatively similar risk is completely unreasonable from a risk perspective and provides incentives for erroneous pricing and high risk-taking.

SBAB expresses that tenant-owned apartments should be at parity with houses in the transition rules, which better reflects the actual risk and is in line with FI's management thereof under Basel 2 and Basel 3.

FI has understanding for the viewpoint of the Swedish Bankers' Association and SBAB that the risk-weighting of exposures collateralised by a tenant-owned apartment that forms the basis for calculating the Basel 1 floor may overestimate the risk in this type of exposure compared with the risk in exposures collateralised by a residential property, such as a single-family dwelling. FI has therefore separately investigated the possibilities of applying a lower risk weight than that stipulated by Basel 1 regulations for this type of exposure in the calculation of the Basel 1 floor. However, FI is of the opinion that there is no such judicial possibility considering the fact that CRR stipulates that the Basel 1 floor shall be calculated based on the own funds that the institutions were obliged to maintain in accordance with the so-called Basel 1 Directives. FI may thus, according to CRR, grant a waiver from the requirement to apply the Basel 1 floor, but not however determine how the floor should be calculated.

5.3 Definition of own funds

The Basel 1 floor prescribes a minimum level for the size of own funds. The definition of own funds has changed in CRR and CRD 4 compared to the Basel 1 Directives. It is therefore important to make clear that it is the new definition of own funds that is applicable even for meeting the Basel 1 floor. This is understood by the fact that Article 500(1)(b) of CRR only refers to the Basel 1 Directives with regard to the calculation of the capital requirement, while there is no such reference for the determination of own funds.

However, own funds shall be adjusted in accordance with Article 500(4) of CRR. The adjustment aims to neutralise the impact that the expected loss amount, calculated with the internal model for credit risk, has on the size of the own funds.

Own funds consist of not only common equity Tier 1 capital but also Tier 1 and Tier 2 capital.[16] Article 500(1)(b) refers to own funds as a whole. There is no specification of how large a share is to consist of common equity Tier 1 capital, Tier 1 capital and Tier 2 capital (as there is in the capital adequacy requirement calculated according to the main rule, i.e. without a floor). This means that there is no requirement under the Basel 1 floor on a certain minimum amount for common equity Tier 1 capital, but rather only for the own funds as a whole.

6 Possible alternative applications of the Basel 1 floor

6.1 The floor rules and the new buffer requirements

6.1.1 Background and FI's opinion

CRD 4 and CRR also introduce, in accordance with the Basel 3 agreement, in addition to the minimum requirement on capital of 8 per cent of the risk-weighted assets, a buffer requirement consisting of a capital conservation buffer of 2.5 per cent, a mark-up for systemic risk (in Sweden 5 per cent),[17] and a countercyclical buffer.[18]

CRR's description of the Basel 1 floor in Article 500, as pointed out earlier, has not changed compared to the Credit Institution Directive. One possible alternative interpretation of CRR is that the new buffers are to be added on top of not only the minimum capital requirement of 8 per cent, calculated in accordance with the main rule without the floor, but also on top of the capital requirement when calculating the Basel 1 floor (provided that the bank has not been granted a waiver from the floor). FI believes, however, that the floor rule should not be applied in this manner but that it shall be applied as a parallel measure, with no relation to the buffer requirements.

The European implementation of the floor is in line with the purpose behind the Basel Committee's agreement. The Committee defined the Basel 1 floor in the Basel 2 agreement from 2005 as a share of risk-weighted assets and not as a share of the nominal capital requirement. A strictly literal application of this

[16] Simplified, Tier 1 capital can be described as capital instruments that fall somewhere between shares and liabilities and Tier 2 capital are loans that in the event of a bankruptcy are subordinate to all of the bank's other commitments. The exact definition is set out in CRR.

[17] Level in accordance with the November Accord. Exactly how the November Accord will be implemented legally due to the new buffer requirements as they are set out in CRD 4 has not yet been decided in detail.

[18] The buffer requirements are expected to enter into force in Sweden during 2014.

method would mean that the floor level expressed in SEK increases following the implementation of the Basel 3 agreement, since not only the minimum capital requirement but also the new buffer requirements should be calculated in relation to the risk-weighted assets as per the floor rules. In this context, it should however be mentioned that the Committee already pointed out in the Basel 2 agreement that Member States are free to make certain adjustments to the floor. However, such adjustments must coincide with the overarching principles, and the national regulations regarding the floor must be transparent.[19] This statement by the Committee implies that the European implementation of the floor does not contradict the Basel Committee's agreement. FI takes the position that the floor's purpose is fulfilled in the best possible manner by the floor being calculated as a share of the capital requirement under Basel 1 and not as a share of risk-weighted assets.

6.1.2 Feedback received and FI's assessment thereof

The Swedish Bankers' Association fully shares FI's view of how the floor should be calculated, and finds that this calculation method is stated plainly and clearly in the provisions of CRR and CRD 4. The Association notes with surprise that FI seems to find that CRR is ambiguously worded as regards the relationship between the floor rules and buffer requirements. The Swedish Bankers' Association cannot see how either CRR or CRD 4 provides scope for such an alternative interpretation. Furthermore, the Association expresses that it is important that FI actively contributes to compliance with the rules of CRR and CRD 4, and that the EBA does not base its regulations on doubtful interpretations of CRR and CRD 4.

FI has been clear about which interpretation of CRR FI considers to be the most accurate and suitable for the Swedish market. FI has also pursued that position within the EBA when the Basel 1 floor was being discussed. FI ascertains, however, that not all EU countries share this interpretation of CRR. For example, it has emerged that the supervisory authority in the UK – the Prudential Regulation Authority – does not intend to allow British banks to cover the Basel 1 floor with the same capital they use to cover the buffer requirements.[20] In other words, in their view the buffer requirements are on top of the Basel 1 floor. In FI's opinion, it is not evident that the UK's interpretation conflicts with CRR, but takes the position that CRR provides scope for many interpretations.

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[19] Section 49 of the Basel 2 agreement from 2005; International Convergence of Capital Measurement and Capital Standards, A Revised Framework.

[20] Strengthening capital standards: implementing CRD IV, feedback and final rules, December 2013, Prudential Regulation Authority

6.2 Application at the consolidated level

FI makes the assessment that the Swedish application of the Basel 1 floor will be applicable at the consolidated level for all of a bank group's exposures, regardless of how the floor is applied in the countries where the group's foreign subsidiaries are domiciled.

As set out in section 6.1, it should potentially be possible to interpret CRD 4 and CRR in a different manner than FI does with regard to how the floor rules should be applied. It is therefore relevant to ask what happens if another country applies the Basel 1 floor differently and a Swedish bank group (i.e. a group in which the parent company is domiciled in Sweden) has one or more subsidiaries in that country. In such a case, which method of calculation should be applied to the exposures in question in the consolidated capital adequacy calculation?

This issue is not expressly handled by CRD 4 and CRR, which is natural since there is no specific national choice in this matter. It is therefore also not possible to apply the Basel 1 floor differently for different companies in the same group at the consolidated level. FI's opinion is therefore that the Swedish application will apply at the group level for the entire consolidated group. Inversely, a potential application in another country will apply to the assets in a foreign group's Swedish subsidiaries at the consolidated level.

7 Transparency

The banks currently publish disclosures about the size of the floor at the same time as they provide information about the bank's capital adequacy in general, for example in annual reports, quarterly reports and other relevant financial statements. The Basel 1 floor's effects on capital requirement are thus already currently reported in a relatively transparent manner.

In order for analysts, investors, customers and the general public to be able to properly understand the bank's capital strength, it is important that the bank reports the floor's effects clearly and openly. This can be achieved by the banks continuing as a minimum to report the lowest level of the amount of own funds as per the Basel 1 floor and the amount by which the own funds have been adjusted[21] for this purpose. It may also be relevant for the banks to further consider how the floor and its effects may be reported in as clear a manner as possible and adapt their disclosures in their financial statements accordingly. Even FI intends, in reports and other publications, to report the floor's significance for the banks' capital situation clearly and openly.

[21] According to Article 500 (4) of CRR.

8 Consequence analysis

8.1 Consequences for affected banks

8.1.1 Own funds requirements

The tables and diagrams below show the effect of the Basel 1 floor for the largest affected bank groups at the group level. From this information it can be deduced that the floor is a binding restriction compared to the total capital requirement under full Basel 3 and the November Accord for Handelsbanken, Landshypotek, Länsförsäkringar Bank and SBAB.

Total capital requirement refers to the capital requirement including a capital conservation buffer of 2.5 per cent and a systemic risk buffer for major banks of 5 per cent of risk-weighted assets.[22] *Minimum capital requirement* refers to the capital requirement excluding the buffer requirements, i.e. 8 per cent of risk-weighted assets. In the analysis of the capital locked in exclusively due to the floor rule, the capital requirement as per Basel 3 without the floor is compared to the capital requirement as per the Basel 1 floor. The difference is thereafter corrected to readjust for the own funds adjustment, in accordance with Article 500(4) of CRR, see table 1 for further information.

[22] The examples in this section assume that the systemic risk buffers are 5 percentage points, as stated in the November Accord. However, exactly how the November Accord will be implemented legally due to the new buffer requirements as they are set out in CRD 4 has not yet been decided in detail.

Table 1: Capital requirement as per full Basel 3 and according to the floor rule as well as information about own funds for the largest affected banks

	Capital requirement as per Basel 3 without the floor*	Capital requirement as per Basel 1 floor	Own funds	Own funds adjustment**	Capital locked in by the floor***
Nordea	214.2	146.4	238.1	7.8	-
Handelsbanken	72.5	80.8	101.4	1.8	6.5
SEB	89.0	72.8	106.9	0.6	-
Swedbank	68.4	61.3	89.3	1.9	-
Landshypotek	1.7	4.0	4.7	0.1	2.2
LF Bank	5.3	7.1	9.2	0.6	1.2
SBAB	4.1	11.0	15.2	0.1	6.8
SEK	7.5	5.4	14.6	0.0	-
Volvo Finans	1.6	1.3	3.0	0.1	-
Total					16.7

Data as per Q3 2013, SEK billion.

* Calculated in relation to RWA as per Q3 2013. Includes the capital conservation buffer of 2.5 per cent for all banks and the systemic risk buffer of 5 per cent for the four major banks.

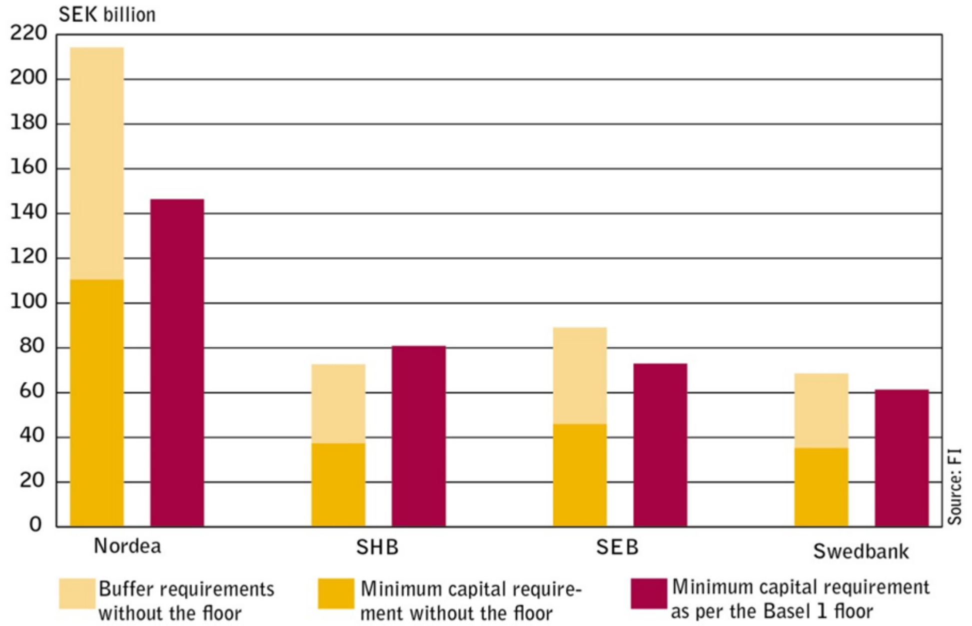
** Adjustment of own funds for the floor, in accordance with Article 500(4) of CRR.

*** The difference between the minimum level of own funds as per the Basel 1 floor (column 2), with deductions for adjustments to own funds (column 4), and the total capital requirement as per full Basel 3 (column 1), if this difference is positive.

All bank groups have own funds that exceed the minimum level of own funds as per the Basel 1 floor, which was expected since the floor is in effect today.

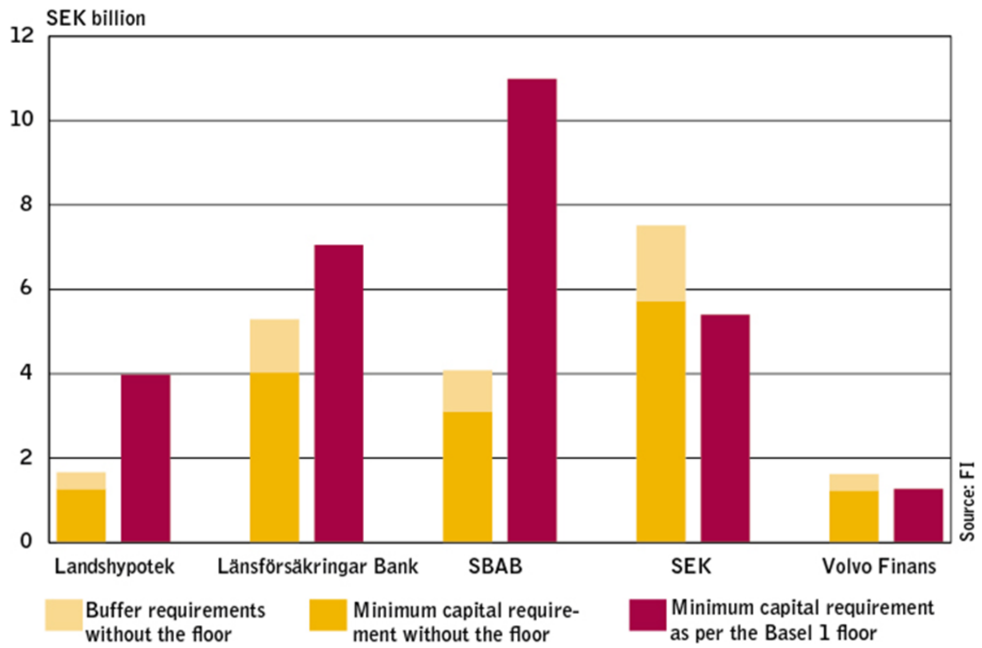
Even most of the banks for which the floor does not constitute a binding capital restriction compared to the total capital requirement as per Basel 3 are affected in that the level of the floor exceeds the minimum capital requirement that applies according to the calculation without the floor. A comparison of the minimum capital requirement without the floor and the minimum capital requirement as in the Basel 1 floor is shown in diagrams 1 and 2. The only bank for which the Basel 1 floor does not constitute a binding restriction in any respect is Svensk Exportkredit (SEK) .

Diagram 1: Capital requirement as per full Basel 3 without the floor, and as per the Basel 1 floor for the four major banks.



Note: The capital requirements are calculated in relation to risk-weighted assets as per Q3 2013. The buffer requirements include a 2.5 per cent capital conservation buffer and a 5 per cent systemic risk buffer. The diagram does not illustrate the adjustment to own funds that shall be made in accordance with Article 500(4) of CRR.

Diagram 2: Capital requirement as per full Basel 3 without the floor, and as per the Basel 1 floor for other banks.



Note: The capital requirements are calculated in relation to risk-weighted assets as per Q3 2013. The buffer requirements include a 2.5 per cent capital conservation buffer. The diagram does not illustrate the adjustment to own funds that shall be made in accordance with Article 500(4) of CRR.

If FI were to grant the banks waivers from the application of the Basel 1 floor, capital that today is locked in the Swedish banking system would have been released. As presented by the above table, the capital locked in the banks exclusively due to the floor rule totals almost SEK 17 billion. This capital stems from four bank groups: Handelsbanken, Landshypotek, Länsförsäkringar Bank and SBAB.

The amounts in this analysis do not take into consideration capital needs and capital planning under Pillar 2, which is the designation of the parts of the capital adequacy regulations that, among other things, regulate FI's assessment of the banks' individual capital needs and the banks' own capital adequacy assessments. This means that the banks' total capital need could exceed the amounts shown here in the tables and diagrams. For example, the data here does not reflect the capital need that arises as a result of FI 's risk weight floor for Swedish mortgages.[23] The exact way in which the own fund requirements in Pillar 2 relate to the Basel 1 floor will be described in more detail in a memorandum on FI's overarching view of Pillar 2. Work on preparing such a memorandum is currently under way at FI.

The fact that the Basel 1 floor entails a higher minimum capital requirement for all affected banks except one is a result of the internal models that the Swedish banks use today in general resulting in significantly lower risk weights than the Basel 1 regulations. This in turn is due to the fact that the Swedish banks have a history, in an international comparison, of low credit losses in the majority of their credit portfolios. The risk weights of the internal models reflect to a large extent the banks' historical credit losses within each segment.

8.1.2 Capital cost

In this section, the consequences of the position to the capital cost of banks, which is not the same as the economic cost, are addressed.

FI's position with regard to the Basel 1 floor entails, as previously mentioned, keeping the structure that exists today. What the consequence analysis intends to highlight is therefore a lost opportunity for savings (lower capital cost due to that the banks could choose to reduce their own funds) and not an additional cost. The cost estimates in this section refer, in other words, to costs the banks already have.

The cost of the banks to hold the capital that is locked in exclusively due to the Basel 1 floor is dependent on a) the extent to which higher own funds reduce the price the bank must pay to borrow funds and b) how much more expensive the funding that fulfils the requirements for being included in own funds is

[23] See Risk weight floor for Swedish mortgages Finansinspektionen. Published on 21 May 2013.

compared with other types of funding.[24] These factors are in turn dependent on a long series of factors that are hard to simply decipher and judge, because, for instance, of the fact that they are interdependent. Such factors include which funding sources the bank in question uses, the return on equity required by the bank's shareholders and the general confidence in the bank among investors (both those who invest in own funds instruments and those offering other funding).

It is thus the case that the better capitalised a bank is, the lower the cost in per cent of the borrowed amount the bank has for its funding, all else equal. These relationships entail that an increase in own funds does not automatically result in a higher total funding cost, but it can.

The funding costs are also determined by which type of capital the bank chooses to use to meet the own funds requirement. As set out in section 5.3, the Basel 1 floor does not set out a requirement on a specific type of capital – i.e. common equity Tier 1 capital, Tier 1 capital or Tier 2 capital – as long as the capital meets the requirements for being included in own funds. Tier 2 capital is normally a cheaper form of funding than Tier 1 capital, which in turn is normally cheaper than common equity Tier 1 capital.

In order to be able to calculate the total capital cost for the own funds requirement under the Basel 1 floor (see Table 1), certain assumptions about the funding costs must be made. Given an assumption that the banks' interest expense for borrowing capital that may be included in own funds exceeds the interest expense for other funding by 3–12 percentage points, the total annual capital cost for the own funds requirement that is exclusively due to the Basel 1 floor will be SEK 0.5 billion to SEK 2 billion (SEK 16.7 billion multiplied by 3 and 12 per cent, respectively). This cost, which the banks already bear today, corresponds to around 3–10 per cent of the total operating profit in 2012 of the four affected bank groups (Handelsbanken, Landshypotek, Länsförsäkringar Bank and SBAB). In this context, FI wishes to emphasise once again that these calculations do not take account of the own funds requirements that may follow from Pillar 2. FI plans, as mentioned, to revert on this matter in a separate memorandum on FI's overarching view of Pillar 2.

An analysis of each individual bank shows that one particular bank bears a large part of the total cost. The bank group that is clearly affected the most in relation to operating profit in 2012 is SBAB; the capital cost for SBAB for the portion that is locked in due to the floor rule corresponds to 40–160 per cent of

[24] It is assumed that the banks do not reduce their total balance sheet due to that they reduce their own funds. It is therefore assumed that the banks replace the funding that fulfils the requirements for being included in own funds with other (cheaper) types of funding.

its operating profit.[25] Once again, however, it should be emphasised that this is not an additional cost, but one already borne by the bank today.
Swedish banks are to a large extent dependent on market funding, both for funding of the assets that may be included in the own funds and for major parts of their other funding. The cost for funding, as previously mentioned, is in turn dependent on the investors' confidence in the capital strength of the Swedish banking system. FI takes the position that by keeping the Basel 1 floor this will help the Swedish implementation of the capital adequacy regulations be perceived as robust and sufficiently conservative, which is also discussed in section 3.2. The fact that the capital will also continue to be locked into the Swedish banking system can also result in keeping down the cost of the banks' funding. Because of the complex relationship between the own funds requirement and funding costs, it is difficult to calculate with any precision the net capital cost of FI's position. The amounts stated above should therefore be viewed as a ceiling for the potential savings for the banks that a maintained Basel 1 floor could perceivably prevent.

8.2 Consequences for competition and the market

8.2.1 Feedback received

The Swedish Bankers' Association finds that, for the banks for which the Basel 1 floor will be the binding restriction, all exposures in a certain category are given the same own funds requirement, so incentives to reduce and price risk disappear. Continued use of the Basel 1 floor thus counteracts sound risk management in the banks, according to the Association.

Landshypotek finds that potential advantages in internal models, such as risk-based pricing, are sharply weakened by risk-insensitive capital adequacy rules, particularly for banks that lend to low-risk segments.

8.2.2 FI's assessment

Since the capital requirement affects the banks' capital cost, and this cost is an important part of the banks' total cost for conducting lending activities, changes in the capital requirement have consequences for competition.

It is very difficult to analyse the effect of keeping the Basel 1 floor on competition between banks and within different market segments. First, the banks for which the floor is binding on a total level are affected in a different and more direct manner than other banks. However, other banks too can be affected to a certain extent due to altered competition (read more about this below).

[25] The Basel 1 floor locks in SEK 7 billion as shown in Table 1. SEK 7 billion multiplied by 3 and 12 per cent, respectively, is SEK 210–840 million, which corresponds to 42–167 per cent of the bank group's operating profit in 2012, which was SEK 503 million.

Second, there are only indirect relationships between the banks' business steering (i.e. the prices they charge their customers, their internal profitability calculations, their portfolio strategy and other means of governance) and the statutory capital requirement. In FI's experience, the farther the statutory capital requirement lies from the banks' own risk perception, the lower the probability that the banks' internal steering and pricing reflect the statutory requirement all the way to the customer. As previously mentioned, the floor is already in place today and the banks have to date chosen to let the floor affect their business steering to different degrees. Some banks may have had an expectation that the floor would not be kept in light of CRD 4 and CRR, which can have affected how they devised their business steering. These banks might potentially reassess their present steering models such that greater importance is attached to the capital requirement calculated using the floor rules.

As expressed by the Swedish Bankers' Association and Landshypotek, the Basel 1 floor may entail that the fundamental intention with the introduction of internal models – to provide banks with an incentive to limit their risks – is partially undermined. The need to limit the effect of the internal models on capital requirements is however largely a consequence of the uncertainties surrounding the reliability of the models, and thus is also partially an expression of calling into question the incentives provided by the models. It should also be emphasised in particular that the capital adequacy regulations are far from the only factor that govern bank lending; the banks should have their own driving forces for applying a sound strategy in their risk-taking.

However, two more general conclusions can be drawn:

Conditions for competition for smaller banks are kept. The Basel 1 floor limits the difference between the banks that use internal models and those that do not. Since it is primarily the major banks that use internal models, the floor makes it easier for smaller banks to compete with the larger banks. The fact that the floor remains in place therefore means that the current conditions for competition are unchanged.

Competition in high risk segments can increase slightly and competition in low risk segments can decrease, all else equal. The internal models for credit risk entail that an individual capital requirement is calculated for every exposure. This capital requirement varies and reflects the banks' internal assessment of risk. In other words, high risk exposures have a higher capital requirement and low risk exposures a lower capital requirement. In the simpler standardised rules in Basel 1, all exposures within the same category are given the same capital requirement, regardless of risk. As long as the Basel 1 floor is a binding restriction for the bank's total level of own funds, the floor rules will therefore mean – all else equal – that the incentives to lend to high risk customers increases while the incentives to lend to low risk customers decreases. This in turn is based on the fact that it is normally possible to charge a higher price the higher the risk of an exposure. If the capital costs do not increase to the same extent, these high risk segments become therefore more profitable while the low risk segment under the same reasoning would be less profitable.

The effect described above, however, can be counteracted by the fact that there is nothing preventing the banks from continuing to apply a risk-differentiated internal distribution of capital even in the future for the banks for which the Basel 1 floor entails a binding capital restriction, even though the margin capital requirement given FI's position is the same for all exposures within one category. FI is positive on the banks differentiating the price charged to the customer based on the risk assessments of the internal models, even if there is a floor for the actual lowest level of the capital requirement. FI follows any changes to the banks' lending strategies within the framework of its supervision.

8.3 Consequences for consumers and society

8.3.1 Consumer's cost to borrow

As presented in the previous section, the fact that the Basel 1 floor will remain in place will affect the prices the banks charge their credit customers. The assessment of if, and in that case the extent to which, this will happen, however, is very uncertain. This uncertainty is due to the reasons already set out in sections 8.1 and 8.2 and that are associated with both difficulties assessing the actual net effect on the affected banks' total funding cost (lost savings) and how this cost impacts the banks' business governance.

The capital requirement affects the price a bank is prepared to offer for a credit in that it affects the capital cost associated with the credit exposure entailed by the commitment. FI's position in terms of the Basel 1 floor does not however involve any new higher capital requirements compared to today. There is hence no reason to believe that the total revenues of banks will change. Potential expected effects relate to a limited redistribution of the capital between different lending segments.

8.3.2 Consequences for the national economy

As presented in section 8.1.1, the Basel 1 floor entails that more capital is locked into the banking system than what would have been the case if FI had approved to waive the floor. A lost savings opportunity, which to some extent can affect consumers' interest expenses, must be weighed against the potential negative effects of a financial crisis. A stable financial system is a cornerstone of the entire national economy.

The fact that capital continues to be locked into the banking system is positive for the banks' ability to withstand financial crises, all else equal. As previously mentioned, FI also believes it is important to keep the Basel 1 floor in order for the Swedish implementation of the capital requirements regulations to be perceived as robust and sufficiently conservative, which in turn affects confidence in the Swedish banks’ capital strength. Strong confidence in the resilience of Swedish firms to financial crises is important, not least in light of the dependence of the Swedish banking system on international capital markets for its funding.

All in all, FI believes that the lost potential savings opportunities that can result from the continued application of the Basel 1 floor in total are more than compensated for by the positive effects that this application would have for financial stability and thereby the national economy as a whole.