M E M O R A N D U M

Date **2014-10-26**

EBA's stress test and Asset Quality Review

Summary

Finansinspektionen's (FI) assessment is that the result of EBA's stress test and AQR does not affect the conclusion of the Stability Report of June 2014[1], i.e. that the major Swedish banks, Nordea, Handelsbanken, SEB and Swedbank are currently satisfactorily capitalised and resilient to a scenario of a sharp deterioration in business conditions. According to FI, the outcome of AQR shows that credit quality in the studied portfolios is sound. In the assessment of credit quality made by FI in the framework of AQR, the level of both nonperforming loans and impairments is somewhat higher than those recognised in the banks' public financial statements. However, this does not mean that revision of the banks' financial reports is necessary, it rather shows that FI´s assessment for the purposes of the AQR and stress test is somewhat more conservative. The extent of additional nonperforming loans and impairments- as assessed by FI- is nevertheless relatively limited.

Background

The implementation of AQR has, where FI is concerned, taken place based on an EBA recommendation[2] directed to supervisory authorities in all EU countries. The recommendation forms part of EBA's efforts to restore confidence in the EU's banking sector.

EBA coordinates the AQR for all EU countries. For banks registered in Member States in ECB's Single Supervisory Mechanism (SSM)[3], AQR is conducted by the national supervisory authorities under the guidance of ECB. For Sweden and other EU countries not in SSM, AQR is performed independently by the national supervisory authority.

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[1] Stability in the financial system, FI Ref. 14-999

[2] https://www.eba.europa.eu/documents/10180/449802/EBA-Rec-2013-04+Recommendations+on+asset+quality+reviews.pdf

[3] Starting in November 2014, ECB will assume its new bank supervision duties as part of the SSM. Hence, ECB will exercise direct supervision of the banks registered in the euro area which ECB has considered to be significant credit institutions. Sweden is not one of the countries that participates in the SSM. ECB is also assuming direct supervision of the Swedish banks' subsidiaries registered in the euro countries, and will hence become a member of the Swedish supervisory colleges for the major banks.

EBA's stress test of resilience in the EU's banking sector has been performed on several occasions since 2010. A specific aspect of the 2014 stress test is that the exercise is conducted in connection with an AQR, providing national supervisory authorities with the option to take into account the AQR results in the stress test. FI has opted to do this, as have most other supervisory authorities in the EU. For banks domiciled in Member States in the SSM, the AQR and the stress tests make up parts of ECB's supervisory review prior to assuming direct supervision of euroarea banks..

Where Sweden is concerned, four banks are covered at consolidated level by EBA's recommendation regarding AQR and EBA's stress tests: Nordea, Svenska Handelsbanken, SEB and Swedbank. In addition, the banks' subsidiaries in Member States in the SSM[4] and in Lithuania, that , are effected by ECB's *comprehensive assessment*[5], because these subsidiaries will be subject to direct supervision by ECB[6]. FI has been assisted in the review of the bank's subsidiaries and a local branch by relevant competent authorities in Norway, Denmark, and the UK.

EBA stress test

The purpose of EBA's stress tests is, in a comparable manner, to study the resilience of the largest European banks in a deteriorated macroeconomic scenario. In jurisdictions such as Sweden, which have opted for linking AQR to the stress tests, the stress tests and AQR are interlinked by the AQR outcome for individual banks being used as the adjusted balance sheet on which the forward-looking stress tests are based.

The stress test has been coordinated by EBA, which has also developed and determined the method for how the banks are to calculate and report results. The national supervisory authorities have been responsible for ensuring that the concerned banks have applied EBA's method.

FI regularly uses stress tests in order to assess resilience in banks' capital adequacy, but the method differs to that employed by EBA. FI's stress test is devised based on FI's knowledge of the banks' portfolios and operations, and experience from former crises that affected Swedish banks. FI's stress test methodology thus has the purpose of reflecting the primary risks to capital adequacy that ensue from the structure of the Swedish financial system and the risk profile of firms[7]. EBA's stress test is instead an inspection of the resilience of the EU's overall banking system, largely using a standardised method that is

[4] Estonia, Finland, Germany and Latvia.
[5] ECB's comprehensive Assessment consists of three parts: AQR, Balance sheet assessment, and stress test.
[6] The aggregated analysis on group level is based on data received by FI up to and including 22 October 2014.
[7] Twice a year in its Stability Report, FI sets out its opinion of financial stability and primary risks.

applied in the same manner to all banks, irrespective of differences in risk profile and local market conditions. This standardisation is necessary for the stress test to be uniformly conducted among all participants.

EBA's stress test method

The macroeconomic conditions for EBA's stress test consist of a baseline scenario in which a number of macro variables are assumed to develop in line with the EU Commission's forecasts, and a stressed scenario in which the European Systemic Risk Board (ESRB) has assigned values to the variables that are assumed to correspond to a sharp deterioration in the state of the economy compared to the forecast. ESRB has adapted its scenario for each Member State, resulting in the ESRB assuming a greater negative change in the stressed scenario for Member States with a relatively positive baseline scenario, which is largely the case for Sweden.

The basis of ESRB's stressed scenario is set out as 1) a sharp increase in interest rates; 2) further weakening of credit quality in EU countries with weak economies; 3) a drop in confidence in public finances due to protracted political reforms; 4) the absence of requisite measures to restore banks' balance sheets.

ESRB has assigned values to macroeconomic variables which, for Sweden, involve a greater deterioration in the state of the economy than for the euro area. Compared with the EU Commission's forecasts for Sweden, the negative deviation in real GDP for Sweden amounts to just over 10 per cent (6.6 per cent for the euro area) and unemployment is assumed to increase by 5.4 percentage points (2.2 percentage points in the euro area) while price deflation of 4.4 per cent is assumed (price inflation of 1.9 per cent for the euro area). A drop in Swedish real estate prices of 25 per cent for residential properties and 19 per cent for commercial properties is assumed (15 and 5 per cent, respectively, for the euro area) in the stressed scenario.

The participating banks have used ESRB's values on the variables of the macroeconomic scenarios to calculate the estimated effects on income statements and balance sheets, and how capital adequacy would be affected. The method that the banks have had to follow for these calculations has been decided by EBA in a specific methodology document[8]. The banks' application of EBA's methods has been validated by the national supervisory authorities. The method involves a number of limitations that affect the outcome, mainly because the banks are not given the opportunity to counteract the effects of the deteriorated scenario by means of e.g. altered pricing, despite funding costs increasing.

[8] https://www.eba.europa.eu/-/eba-publishes-common-methodology-and-scenario-for-2014-eu-banks-stress-test

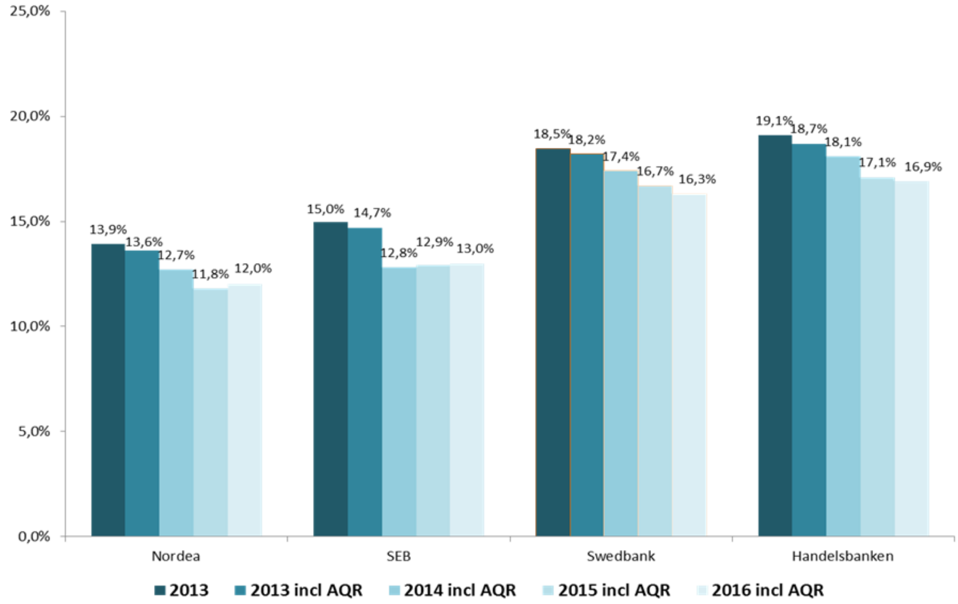
The results for the Swedish banks

EBA's stress test (like ECB's supervisory review) is based on a capital requirement of 8 per cent, measured as common equity Tier 1 capital ratio. In the stressed scenario, 5.5 per cent is used as a threshold for the banks. Because EBA has opted to use the Capital Requirements Directive (2013/36/EU) with the national options (e.g. through phasing-in) as applied by the member states, the capital ratios in EBA's stress test are not entirely comparable between different Member States.

In EBA's stress test, all Swedish banks show common equity Tier 1 capital ratios that drop by at most 1.8–1.9 percentage points in the stressed scenario. In absolute numbers, AQR and EBA's stressed scenario lead on the whole to an estimate of common equity Tier 1 capital ratios amounting to between 11.8 per cent and 16.9 per cent at minimum. The calculations have been based on the banks' financial position at 31/12/2013[9].

As described above, the results of EBA's stress test are not linked in any way to the stress tests performed by FI in its annual review and evaluation of the capital requirements for the major Swedish banks (SREP process). More information about both ESRB's scenario assumptions and a summary of the results of all participating banks is available on EBA's website: http://www.eba.europa.eu.

Chart: Common equity Tier 1 capital ratio, after EBA's stress test adjusted for the AQR result (Note: 2014, 2015, and 2016 with AQR adjustment).



[9] Appendix 1 provides an overview of the result of EBA's stress test, including the adjustment resulting from the AQR outcome.

Asset Quality Review (AQR)

The methodology for conducting AQR has been stipulated by EBA in the form of a recommendation directed to the national supervisory authorities in the EU. EBA has also taken responsibility for coordinating and compiling the aggregate national AQR results at EU level. FI is responsible for the assessment for Swedish banks at group level.

The portfolios that have been subject to closer review consist of: lending for commercial real estate, lending to SMEs, lending to large corporates and mortgages.

No review has been performed of the banks' methods to determine the level of collective impairments for Swedish mortgages, because in previous, comprehensive mortgage surveys conducted by FI, FI has assessed that the risk of an underestimated level of impairment is low. There has been no review by FI of the model for collective impairment for SME customers because a large proportion of the banks' impairments for corporate customers is being effected through specific impairment.

EBA's recommendation presupposes that the supervisory authority conducts a review in which assessment of asset quality for the purpose of the stress test is performed based on a judgement-based application of IFRS. In accounting, the banks apply international accounting standards (IFRS), which are issued by the International Accounting Standards Board (IASB). IFRS is a set of principle-based regulations, so assessments must be made in accounting, such as of the impairment requirement in credit portfolios. The assessments made by FI can thus differ from those made by the banks. The discrepancy does however not constitute a reason for which a restatement of the banks' financial statements is necessary. It rather shows that FI assessment is somewhat more conservative than the assessment made by the banks. The additional impairment requirements identified by FI in accordance with the AQR are only used in connection with EBA's stress tests.

The additional impairment requirements identified by FI affect the input value of the banks' common equity Tier 1 capital in EBA's stress test. FI have in the calculation of additional impairment requirements excluded any potential tax adjustment. In this context, no account has been taken of the existing own funds deduction, which refers to the difference between the expected loss amount and actual provisions. The impact on common equity Tier 1 capital from AQR has been relatively limited, amounting to between 0.3 and 0.4 percentage points.

The AQR has also included an assessment of the size of banks non – performing exposures. EBA has established a definition of non-performing exposures in order to increase comparability between non-performing exposures in different banks. The new definition applies as of 1 July 2014. In summary, a loan is classified according to EBA as a non-performing exposure where the loan is 90 days past-due or if there is a risk of defaulted payments. A loan that has been classified as impaired in the financial statements or that has been classified as defaulted in capital adequacy shall always be classified as a non-performing exposure according to EBA's definition. Since AQR is performed on figures for 31 December 2013, EBA has recommended that a simplified definition of nonperforming exposures should be used[10]. The simplified definition recommended by EBA has been used by FI.

Method

The AQR has been conducted in the form of credit risk inspections, as a part of FI's on-going supervision. The inspections have been conducted in accordance with FI's supervisory procedure.

At the same time, FI has, in its review, followed EBA's recommendation that sets out an overarching framework for the methodology. The reviews performed by supervisory authorities for the subsidiaries of Swedish banks in the euro zone have, besides this framework, also followed ECB's methodology for conducting AQR. FI has opted, as far as possible, to adapt its methodology to that used by the ECB in order to facilitate compiling a consolidated result for the banking group.

In the initial phase of AQR, the portfolios to be included in the sample review were decided. Sampling was conducted in consultation with the supervisory authorities included in each supervisory college (one college for each bank) and the decision was based on the size and risk level of the portfolios. In AQR, there was a dialog held between the supervisory authorities of Norway, Denmark, Finland, Estonia, Latvia, Lithuania, Germany and the UK.

The second phase consisted of a sample review of a large number of credit files in the selected portfolios. In the jurisdictions where the AQR was conducted by FI or by other supervisory authorities on behalf of FI, around 2,500 files were reviewed. The results from the assessments of impairment requirements for the individual credits included in the sample were extrapolated to portfolio level[11].

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[10] Non-performing exposures are defined as:

- Every material exposure that is 90 days past-due even if it is not recognized as defaulted or impaired
- every exposure that is impaired
- every exposure that is in default according to CRR

Previously used terms in financial statements such as "nonperforming loans" and "impaired loans" somewhat resemble EBA's definition of nonperforming exposures because those terms also cover loans past due and impaired.

[11] The extrapolation involved the identified future impairment requirement also being applied to credits that were not included in the sample review, but which are in the same portfolio and which have a similar exposure and risk level.

As mentioned above, extrapolation has only been applied to portfolios containing corporate credits, because individual impairment rarely occurs in the mortgage portfolios.

As mentioned above FI has not reviewed banks' methods for determining the level of collective impairments. However, ECB's methodology includes a review of the banks' methods for determining the collective impairment level. Because of this difference in methodology, the reviews conducted within and outside of the euro zone are not fully comparable.

Overall result for Swedish banks

As mentioned, in AQR, FI has assessed the level of nonperforming exposures according to EBA's simplified definition. Compared with the banks' level of nonperforming exposures in their 2013 annual reports, the share of nonperforming exposures in accordance with the new definition rose, and the increase is between 0.11 and 0.46 per cent of total exposure amount.

On the whole, according to their financial statements, the banks have recognised impairments in the amount of EUR 4,628 million, corresponding to 0.41 per cent of total exposure. Following completed AQR, an additional estimated impairment requirement based on an AQR perspective has been estimated to equal a total amount of around SEK 5,700 million, corresponding to 0.51 per cent of total exposure. See Appendix 1 for a summary of the result and the result on each bank.

Overall result for Svenska Handelsbanken AB

The AQR has been performed by FI. For the UK branch, the review has been performed by the UK supervisory authority (PRA) on behalf of FI[12].

The overall exposure for Svenska Handelsbanken is EUR 264,171 million, of which the bank classified 0.29 per cent as nonperforming exposures in the 2013 annual report. FI has assessed the level of nonperforming exposures in accordance with EBA's new definition at 0.42 per cent.

In the 2013 annual report, the bank recognised impaired loans of EUR 395 million, equalling 0.15 per cent of total exposure. Following completed AQR, an additional estimated impairment requirement based on an AQR perspective has been estimated to equal a total amount of around EUR 635 million, corresponding to 0.24 per cent of total exposure.

The total amount that has affected the input value in EBA's stress test amounts to EUR 240 million. Because of the adjustment, common equity Tier 1 capital changes from EUR 10 267 million to EUR 10 027 million.

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[12] There are some methodological differences between the AQRs performed by FI and the PRA.

Overall result for Nordea Bank AB

The AQR has been performed by FI except for the Finnish subsidiary, which has been reviewed by the Finnish supervisory authority in close cooperation with the ECB and using the ECB methodology. In Denmark and Norway, the review has been performed by the respective local supervisory authorities on behalf of FI and by using FI´s methodology.

The overall exposure for Nordea Bank is EUR 470,844 million. In the 2013 annual report, the bank identified 1.55 per cent as non-performing exposures in the annual report for 2013. FI has assessed the level of non-performing exposures in accordance with EBA’s new definition at 1.87 per cent.

The bank has in the annual report recognised impairments of EUR 2,982 million, equalling 0.63 per cent of total exposure. Following completed AQR, an additional estimated impairment requirement based on an AQR perspective has been estimated to equal a total amount of around EUR 3,472 million, corresponding to 0.74 per cent of total exposure. The amount was partially affected by the completed review of the bank’s method for collective provisions in Nordea Bank Finland.
In Nordea Bank Finland, adjustments of EUR 62 million were made for fair value assets. The adjustment was mainly made for the valuation of CVA (Credit Valuation Adjustment).

The total amount that has affected the input value in the stress test is EUR 552 million. Because of the adjustment, common equity Tier 1 capital changes from EUR 22,798 million to EUR 22,246 million.

Overall result for SEB

Outside the Eurozone, the AQR has been performed by FI and the Lithuanian supervisory authority (Bank of Lithuania). For the bank´s subsidiaries inside the Eurozone, the AQR has been performed by the supervisory authorities in Estonia, Germany and Latvia, in close cooperation with the ECB and using ECB´s methodology.

The overall exposure for SEB is EUR 206,684 million. The bank has identified 0.72 per cent as non-performing exposures. FI has assessed the level of non-performing exposures in accordance with EBA’s new definition at 1.18 per cent.

The bank has in the annual report recognised impairments of EUR 851 million, equalling 0.41 per cent of total exposure. Following completed AQR, an additional estimated impairment requirement based on an AQR perspective has been estimated to equal a total amount of around EUR 1,047 million, corresponding to 0.51 per cent of total exposure.

Adjustments of EUR 4 million were made by the supervisory authorities in the euro zone for valuation of fair value assets. The adjustment was mainly made for the valuation of CVA.

The total amount that has affected the input value in EBA’s stress test is EUR 200 million. Because of the adjustment, common equity Tier 1 capital changes from EUR 10,186 million to EUR 9,986 million.

Overall result for Swedbank

Outside the Eurozone, the AQR has been performed by FI and the Lithuanian supervisory authority (Bank of Lithuania). For the bank´s subsidiaries inside the Eurozone, the AQR has been performed by the supervisory authorities in Estonia and Latvia, in close cooperation with the ECB and using ECB´s methodology

The overall exposure for Swedbank is EUR 183,284 million. In the 2013 annual report, the bank identified 0.46 per cent as non-performing exposures. FI has assessed the level of nonperforming exposures in accordance with EBA’s new definition at 0.57 per cent.

The bank has in the annual report recognised impairments of EUR 400 million, equalling 0.22 per cent of total exposure. Following completed AQR, an additional estimated impairment requirement based on a supervisory perspective has been estimated to equal a total amount of around EUR 546 million, corresponding to 0.30 per cent of total exposure.
Adjustments of EUR 2 million were made by the supervisory authorities in the euro zone for valuation of fair value assets. The adjustment was mainly made for the valuation of CVA.

The total amount that has affected the input value in the stress test is EUR 148 million. Because of the adjustment, common equity Tier 1 capital changes from EUR 9,038 million to EUR 8,890 million.

Links and definitions

Link to EBA’s recommendation on asset quality review (EBA/REC/2013/04) directed to all of the EU’s supervisory authorities:
http://www.eba.europa.eu/documents/10180/449802/EBA-Rec-2013-04+Recommendations+on+asset+quality+reviews.pdf

Link to ECB´s press release of October 23, 2013 announcing the start of the Comprehensive Assessment in advance of assuming the supervisory role:

Appendix 1

MEUR

Summary of stress tests results including AQR adjustment, expressed as impact on CET 1 ratio

	Starting point 2013 CET1 ratio	Starting point 2013 CET1-ratio, AQR adjusted	Total impact AQR, MEUR	Impact AQR	CET1 ratio 2014	CET1 ratio 2015	CET1 ratio 2016	Stress impact, peak-to-bottom	Stresstest + AQR, peak-to-bottom
Nordea	13,9%	13,6%	552	0,4%	12,7%	11,8%	12,0%	1,8%	2,2%
SEB	15,0%	14,7%	200	0,3%	12,8%	12,9%	13,0%	1,8%	2,1%
Handelsbanken	19,1%	18,7%	240	0,4%	18,1%	17,1%	16,9%	1,8%	2,2%
Swedbank	18,5%	18,2%	148	0,3%	17,4%	16,7%	16,3%	1,9%	2,2%

Summary of AQR results

MEUR

Bank	Total exposures	Non performing exposures, before AQR	Adjustments on non performing exposures	Non perfoming exposures, post AQR	Provisions, before AQR	Adjustments to provisions	Total provisions, post AQR	Adjustments on available capital for fair value assets	Total adjustments of CET 1 for stress test purposes
Nordea Bank AB	470 844	7 283	1516	8 799	2 982	490	3472	62	552
Skandinaviska Enskilda Banken AB	206 684	1 484	944	2 428	851	196	1047	4	200
Svenska Handelsbanken AB	264 171	777	323	1 100	395	240	635	0	240
Swedbank AB	183 284	841	195	1 036	400	146	546	2	148
Totalt	**1 124 983**	**10385**	**2978**	**13 363**	**4628**	**1072**	**5700**	**68**	**1140**

Summary of AQR results, diveded by country of the authority perfoming the review on behalf of FI or in close cooperation with FI

Nordea Bank AB

Country	Adjustments on non performing exposures	Adjustments to provisions due to sample file review	Adjustments to provisions due to extraploation of findings	Adjustments to provisions due to collective provisioning review	Adjustments on available capital for fair value assets	Total adjustments of CET 1 for stress test purposes
Sweden	147	131	5	0	0	136
Finland	1368	164	67	122	62	415
Denmark	1	1	0	0	0	1
Norway	0	0	0	0	0	0
Totalt	**1516**	**296**	**72**	**122**	**62**	**552**

SEB

Country	Adjustments on non performing exposures	Adjustments to provisions due credit file review	Adjustments to provisions due to extraploation of findings	Adjustments to provisionsdue to collective provisioning	Adjustments on available capital for fair value assets	Total adjustments of CET 1 for stress test purposes
Sweden	336	70	4	0	0	74
Estonia	190	13	7	0	0	20
Lithuania	180	36	4	-21	3	21
Latvia	97	45	11	0	1	57
Germany	140	31	0	-4	0	27
Totalt	**945**	**194**	**26**	**-25**	**4**	**199**

Svenska Handelsbanken AB

Country	Adjustments on non performing exposures	Adjustments to provisions due credit file review	Adjustments to provisions due to extraploation of findings	Adjustments to provisions due to collective provisioning review	Adjustments on available capital for fair value assets	Total adjustments of CET 1 for stress test purposes
Sweden	323	188	4	0	0	192
UK	0	48	0	0	0	48
Totalt	**323**	**236**	**4**	**0**	**0**	240

Swedbank

Country	Adjustments on non performing exposures	Adjustments to provisions due credit file review	Adjustments to provisions due to extraploation of findings	Adjustments to provisions due to collective provisioning review	Adjustments on available capital for fair value assets	Total adjustments of CET 1 for stress test purposes
Sweden	55	99	0	0	0	99
Estonia	77	36	1	0	0	37
Lithuania	8	4	1	0	0	5
Latvia	56	3	1	0	2	6
Totalt	**195**	**143**	**3**	**0**	**2**	**148**