REGERINGSKANSLIET
Ministry of Finance

Financial Markets Department
Dnr: Fi2015/09421/V

FINANSINSPEKTIONEN

Banking
Dnr: 15-15660

SVERIGES RIKSBANK

Financial Stability Department
Dnr: 2015-00740

European Commission

DG Financial Stability

Financial Services and Capital Markets Union

CALL FOR EVIDENCE

EU REGULATORY FRAMEWORK FOR FINANCIAL SERVICES

Stockholm, 22 December 2015

Ministry of Finance **Finansinspektionen** **Sveriges Riksbank**

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Q1) Unnecessary regulatory constraints on financing*: the Commission launched a consultation in July on the impact of the Capital Requirements Regulation on bank financing of the economy. In addition to the feedback provided to that consultation, please identify undue obstacles to the ability of the wider financial sector to finance the economy, with a particular focus on SME financing, long-term innovation and infrastructure projects and climate finance. Where possible, please provide quantitative estimates to support your assessment.*

As expressed in our reply to the consultation launched in July, banks' ability to provide financing to the EU economy in the future is an important factor in stimulating jobs and growth[1]. Capital regulations can help preserve this ability throughout the economic cycle, but the exact degree of regulation that leads to the optimal outcome in terms of financial stability and long-term growth is, however, subject to debate. Our view is that the net effects of the CRR and CRD IV reforms carried out in light of the financial crisis are positive. Overall, our position is that the regulations put in place in response to the financial crisis have not been overly strict. Ambitious attempts to assess the net effect of recent regulatory reform measures were made a few years ago by the BIS, but also the OECD and others. The results generally point in one direction: that the net effect of reforms is expected to be positive.[2] However, these studies were mainly conducted before the Basel 3 requirements came into place, so an updated assessment of the impact of the new regulations during the last couple of years is highly motivated.

As such, we welcome a thorough cumulative impact assessment of recent reforms, but it is important to keep in mind that we are still in an early stage of implementation. Many new reforms have only recently been implemented, and some are not even in place yet. We are of the opinion that market participants should now be given time to adapt to the new environment, both in respect of new regulation, but also more conjunctural factors.

Without prejudging the evidence gathered by the Commission in reply to this consultation, we believe some modifications to the regulatory environment could potentially be justified, for example, ensuring a proportionate treatment for smaller institutions with less risky business models (especially investment firms). In the CRD IV, for instance, there is specific mention of giving broader scope to the principle of

[1] http://www.regeringen.se/globalassets/regeringen/dokument/finansdepartementet/pdf/151007_the-swedish-government-and-the-swedish-authorities-common-answer-to-the-commission-consultation-paper-on-the-possible-impact-of-the-crr-and-crd-iv-3.pdf

[2] See for instance OECD working papers no.844 "Macroeconomic impact of Basel III" February 2011, BIS Macroeconomic Assessment Group "Assessing the macroeconomic impact of the transition to stronger capital and liquidity requirements" December 2010 and BIS Basel Committee on Banking Supervision "An assessment of the long-term economic impact of stronger capital and liquidity requirements", August 2010.

proportionality – and therefore possibly some lesser administrative requirements for smaller firms.[3]

We would, however, caution against making any large changes to the regulatory agenda which has been agreed during the last couple of years. Firstly, we do not see the post crisis-cumulative regulatory landscape as overly strict, and believe that in order to ensure long-term growth we need sufficiently strict regulatory standards. During the last few years, economic conditions across the EU have not been consistent, with some countries experiencing better economic conditions than others. There have been suggestions that the regulation put in place in response to the crisis has been a “brake” on the European economy, yet for those countries that have experienced better economic conditions we have not seen a drop in lending to the real economy, with lending levels actually being maintained. The observed slowdown in some countries is more likely explained by other factors and we believe it would be more fruitful to address these, rather than adjusting the regulation for all EU member states. As an example, even though Swedish banks have had to abide by stricter capital requirements than some of their European peers, high levels of lending to the corporate sector have been maintained[4].

Secondly, any major revisions at this stage of implementation could lead to future regulatory uncertainty within the EU - i.e. it is challenging for market participants to resource compliance with EU regulations if they suspect that the rules will be revised soon again in the future, sometimes even before they are implemented. It should also be ensured that EU regulation is fully compliant with the already agreed international financial regulatory standards that apply to systemically important banks. This could also help to improve non-European investors’ confidence in European capital markets.

[3] Some provisions of the CRD IV exclusively direct requirements to “institutions that are significant in terms of their size, internal organization and the nature, scope and complexity of their activities”, such as article 76 para 3, article 77 para 1, article 88 para 2, 91 para 3, and article 95 para 1 CRD IV.
4 Kreditbarometern, page 7, figure 6, www.fi.se/upload/43_Utredningar/50_Statistik/40_Kreditmarknadsbarometern/2014/kmb_kv2_2014n.pdf

***Q2) Market liquidity:** please specify whether, and to what extent, the regulatory framework has had any major positive or negative impacts on market liquidity. Please elaborate on the relative significance of such impact in comparison with the impact caused by macroeconomic or other underlying factors.*

There are diverging global trends regarding market liquidity. Following the financial crisis, some products or market segments have seen lower liquidity conditions compared to the pre-crisis environment, while for others they have remained unchanged. In some less common cases, liquidity has even improved. It is worth noting that the deterioration in market liquidity experiences in some segments have so far not had any negative impact on primary markets.

There are several reasons that may explain changes in market liquidity, both conjunctural and more structural. Market liquidity was, for many financial instruments, ample in the period of rising asset prices before the crisis but sharply deteriorated as the crisis unfolded, as is often the case in periods of falling asset prices and tighter funding conditions as dealers become more risk averse. These high levels of market liquidity prior to the crisis were to some extent the result of an under-pricing of risk and liquidity services and are therefore not suitable as a reference point. Indeed, the crisis was, in a sense, the realisation that the pre-crisis "wall of liquidity" was an illusion.

During the years following the crisis there are two structural reasons that seem to explain the current situation in market liquidity. First, in the years that immediately followed the crisis, banks started to review their business models and prioritised business lines that generated the best risk adjusted return on capital employed. Commitment to market-making activities declined, with a withdrawal from segments where the income was not sufficient to compensate for the risk taken. Much of this decline in fact occurred prior to the announcement of new regulation[5]. Though these withdrawals had a negative impact on market liquidity, sometimes other segments benefited where dealers decided to increase their market-making commitment. Several banks seem to prefer being active in segments with high turnover ratios such as benchmark government bonds while they have reduced their presence in the trading of corporate bonds, due to increased focus on the cost of the capital required to fund their inventories.

Second, many people now argue that the new regulatory framework may also have had a negative impact on market liquidity, with some regulatory measures appearing to have directly affected market participants' capital requirements.[6] However, it should be kept in mind that the intended outcome of the new regulatory framework is to generate a positive impact on market liquidity provision. By making banks more robust, their market-making services should become smoother since they are then able to continue to act as liquidity providers in times of more volatile markets when

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[5] http://www.bis.org/publ/cgfs52.pdf
[6] For example, the Basel 2.5 package regarding revised capital requirements for trading book exposures.

liquidity provision is needed the most. As such, the overall effect on market liquidity is somewhat uncertain at this juncture.

In addition, asset prices have been rising steadily since the trough in 2009 and the development of electronic trading has increased price transparency. Together these have contributed to the maintenance of market liquidity at fairly unchanged levels in most markets. As such, our current view of liquidity conditions may well need to be revised in the future.

It is therefore, in our opinion, very challenging to assess the exact significance of each and every driver behind the change in market liquidity. Market liquidity varies over time and is never static. We welcome the initiative to try to evaluate the impact of regulation on market liquidity but caution that it may well be too early to draw clear conclusions, not least because market participants are currently trying to adapt to the new regulatory environment and the non-steady state funding conditions due to conjunctural factors.

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Q3) Investor and consumer protection: *please specify whether, and to what extent, the regulatory framework has had any major positive or negative impacts on investor and consumer protection and confidence.*

It is not an easy task to answer whether investors and consumers are more or less protected or confident now than they were before the crisis hit. While a lot of regulatory work has been done to strengthen consumer protection, new market conditions mean new challenges to consumers. More individual choices are to be made (for example through the development from Defined Benefit to Defined Contribution pension schemes in most of Europe) but factors such as increasing complexity of products make these choices difficult. At the same time, the low interest rate environment might give rise to new challenges for investors and consumers, as it forces the market to take on more risk to maintain nominal returns.

When it comes to regulation, the general picture is that much of the consumer protection-specific regulation has yet to be adopted or fully implemented. In some cases, the new regulations are revised versions of older legal acts from before the time window covered by this review. This is the case with the directive on markets in financial instruments (MiFID II), the directive on payment services (PSD 2) and the insurance distribution directive (IDD).

In other cases, it is a matter of new regulation, for example the mortgage credit directive (MCD), the payment account directive (PAD) and the regulation on key information documents for packaged retail and insurance-based investment products (PRIIPs). The full effects of these legal acts are impossible to evaluate, given that they have not yet been implemented.

That said, overall we are supportive of the objective to strengthen the position of investors and consumers and to do this in a harmonised way for different sectors and jurisdictions. We especially support such consumer protection-specific regulation that highlights the responsibility for companies to ensure a sufficient conduct of business in the relation with their customers. Examples of such regulation include rules on third-party payments in connection to financial advice and insurance mediation, as well as rules on increased responsibility for companies to consider the need and characteristics of target markets when they design new products.

Regulation in the form of detailed information requirements (such as the Key Information Document for PRIIPs, the Fee Information Document under PAD, and the Insurance Product Information Document under IDD) can help to ensure that investors and consumers receive clear and accurate information. Like all regulation, however, these types of rules can also have weaknesses. For example, overly detailed information disclosures may be both challenging for consumers to understand, and create an administrative burden for companies and regulators.

***Q4) Proportionality / preserving diversity in the EU financial sector**: are EU rules adequately suited to the diversity of financial institutions in the EU? Are these rules adapted to the emergence of new business models and the participation of non-financial actors in the market place? Is further adaption needed and justified from a risk perspective? If so, which, and how?*

Regarding questions of proportionality, it is not, a priori, clear that applying different sets of minimum rules to credit institutions only on the basis of size is justified. We would, however, support investigating the effects of allowing simpler, but no less strict, capital requirements for smaller credit institutions in certain specific areas, especially given that the Basel agreements are intended to apply only to large internationally active banks.

As stated in our reply to Q1, some modifications to the regulatory environment could potentially be justified, for example ensuring a proportionate treatment for smaller institutions with less risky business models (especially investment firms). The CRD4, for instance, exclusively directs requirements to “institutions that are significant in terms of their size, internal organization and the nature, scope and complexity of their activities”, such as article 76 para 3, article 77 para 1, article 88 para 2, 91 para 3, and article 95 para 1.

It is also important that regulations do not hinder a member state from applying stricter requirements than suggested by minimum standards in cases where this is deemed necessary for financial stability purposes, such as the stricter capital and liquidity requirements already implemented in Sweden for our four largest banks.

There are, however, challenges in the implementation and design of proposals on proportionality and we look forward to the results of further work in this area.

Q6) Reporting and disclosure obligations: *the EU has put in place a range of rules designed to increase transparency and provide more information to regulators, investors and the public in general. The information contained in these requirements is necessary to improve oversight and confidence and will ultimately improve the functioning of markets. In some areas, however, the same or similar information may be required to be reported more than once, or requirements may result in information reported in a way which is not useful to provide effective oversight or added value for investors.*

Please identify the reporting provisions, either publicly or to supervisory authorities, which in your view either do not meet sufficiently the objectives above or where streamlining/clarifying the obligations would improve quality, effectiveness and coherence. If applicable, please provide specific proposals.

Specifically for investors and competent authorities, please provide an assessment whether the current reporting and disclosure obligations are fit for the purpose of public oversight and ensuring transparency. If applicable, please provide specific examples of missing reporting or disclosure obligations or existing obligations without clear added value.

For reporting and disclosure obligations, the quality of instructions can be improved in some areas. Clearer instructions explaining the information required (and the form it should be provided in) would be valuable for both competent authorities as well as the firms themselves.

One specific example of a rule that could benefit from such a change is CRR Article 437(1) which requires institutions to disclose information on full reconciliation of own funds items to audited financial statements. The RTS 1423/2013 with regard to disclosure of own funds requirements addresses this requirement in article 2 and Annex I. However, no template or clear instructions on what form this information should have are provided. Including such a template and instructions in the RTS would make it easier for competent authorities to analyse and compare the information and possibly also to clarify the requirement for institutions as well.

Q7) Contractual documentation: *standardised documentation is often necessary to ensure that market participants are subject to the same set of rules throughout the EU in order to facilitate the cross-border provision of services and ensure free movement of capital. When rules change, clients and counterparties are often faced with new contractual documentation. This may add costs and might not always provide greater customer/ investor protection. Please identify specific situations where contractual or regulatory documents need to be updated with unnecessary frequency or are required to contain information that does not adequately meet the objectives above. Please indicate where digitalisation and digital standards could help to simplify and make contractual documentation less costly, and, if applicable, identify any obstacles to this happening.*

We welcome the Commission's revision of the prospectus directive aimed at reducing the administrative burden for companies. One important measure is the proposed alleviated prospectus regime for secondary issuances. This should reduce unnecessary reporting of already published information.

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Q13) Gaps: *while the recently adopted financial legislation has addressed the most pressing issues identified following the financial crisis, it is also important to consider whether there are any significant regulatory gaps. Please indicate to what extent the existing rules have met their objectives and identify any remaining gaps that should be addressed.*

First of all, as noted by the Basel III Regulatory Consistency Assessment Program (RCAP), there are some gaps in the EU regulation where it is not in line with already agreed global standards for systemically important banks. Although the EU must always make its own assessment of the design of new regulations, we believe that ensuring EU regulation is fully compliant with international financial regulatory standards could help to improve non-European investors' confidence in European capital markets, potentially making them more willing to invest in Europe, and further enhancing economic growth.

There are a number of reforms in the pipeline which we believe are important for the EU to implement, these include inter alia:

1) **Reducing excessive variability of risk-weighted capital outcomes and strengthening the capital framework**
   Measures to reduce excessive and unwarranted variability of risk-weighted capital outcomes and an increase in the capital requirement for certain exposure classes will form an important piece of the post-crisis reform package for bank capital requirements. Studies tend to identify unmotivated and excessive variations in banks' regulatory capital requirements based on their internal models. This affects confidence negatively, and is imprudent regulation. Therefore, the ongoing work in different fora to address excessive variability in risk-weighted asset calculations in order to improve credibility, consistency and comparability in bank capital ratios, is highly motivated and should be actively supported.

   In order to secure confidence for EU financial stability and also for the real economy, it is imperative that the post-crisis reform agenda is completed in a timely manner and prudently calibrated so that the capital requirements framework is sufficiently robust.

2) **Implementation of leverage ratio requirement**
   One of the drivers behind the latest global financial crisis was an overreliance on leverage. Consequently, the BCBS has developed the leverage ratio monitoring requirement with a view to migrate towards a pillar 1 requirement. Given the role of leverage in financial crises, it is important that the EU monitors the development of capital levels ahead of the introduction of the leverage ratio as well as best practice in its implementation. In that vein we also encourage the EU to proceed and implement the leverage ratio as a pillar 1 requirement, as many other jurisdictions have already done.

However, focusing on just one regulatory measure can lead to regulatory arbitrage. As such, we strongly support the multi-pronged approach being outlined for the future regulatory framework with a well-calibrated combination of risk-sensitive and risk-insensitive measures which should lead to a more robust regulatory framework which is harder to arbitrage.

3) **Implementation of NSFR**
The NSFR is an integral part of the global regulatory reform agenda, and a globally agreed minimum standard in the Basel Committee. To minimise international discrepancies, it is crucial that implementation of NSFR in EU legislation is in line with the global agreement regarding definition, level and timeliness for systemically important banks. Whilst we agree that NSFR must be met at all times, the EU should consider what the appropriate consequences should be for a regulatory breach.

4) **Risk weights / large exposure limits for sovereign exposures**
Like all exposures, sovereign exposures entail risks, but at present the risk-weights allocated to sovereign exposures can in practice be set at zero in the EU for most sovereigns. This represents a “subsidy” to sovereign debt versus private debt; a situation that could result in a suboptimal allocation of debt in the markets and lower economic growth. Removing impediments to economic growth is particularly important in the current low-growth environment being experienced in Europe.

We welcome the work on-going internationally (through the BCBS Task Force and BIS Economic Consultative Committee as well as the EFC High Level Working Group on the Regulatory treatment of Sovereign exposures at the EU level) to review the regulatory treatment of sovereign exposures and develop policy options in response. In that context it is worth noting the unsatisfying situation that the EU is currently materially non-compliant with Basel regulations, partly because it allows banks applying the IRB approach an exemption for sovereign exposures which can lead to a zero risk weight being applied. This issue should be addressed in the short term.

5) **Standards for interest rate risk in the banking book**
We believe that development of these international standards is an important part of the overall regulatory framework. Though challenging to reach agreement on, we do not believe their development should be de-prioritised.

6) **TLAC should be implemented in a timely manner in the EU**
Recognising that the EU has already taken important steps to improve the resolvability of banks through the introduction of BRRD and MREL, we support the TLAC standard as an important step to end the too-big-to-fail problem and support its timely and effective implementation in the EU. By facilitating an orderly

resolution of globally systemically important banks, TLAC, as well as the new BRRD framework, reduce moral hazard and implicit state guarantees as well as financial stability risks. Even with conservative assumptions about costs and benefits, macroeconomic impact assessments of the TLAC standard suggest large positive social effects from its introduction.

7) A resolution regime for CCPs

A resolution regime for CCPs is needed and further work in this area, in line with agreements among global standard setters, is thus very welcome. We agree with prioritizing resolution of CCPs at this stage, but we also see a clear need for a resolution regime for other financial infrastructure companies as well (e.g. FMIs).

8) Other important reforms

Two other important reforms that are not as clearly in the pipeline, nor currently being negotiated, are intraday liquidity and capital requirements for settlement risk. We believe these issues would best be handled in a global setting.

Q14) Risk: *EU rules have been put in place to reduce risk in the financial system and to discourage excessive risk-taking, without unduly dampening sustainable growth. However, this may have led to risk being shifted elsewhere within the financial system to avoid regulation or indeed the rules unintentionally may have led to less resilient financial institutions. Please indicate whether, how and why in your view such unintended consequences have emerged.*

Even though capital and liquidity requirements for Swedish banks are amongst the strictest in Europe, we have so far seen only limited evidence of risk being shifted to other parts of the Swedish financial system. The Swedish corporate bond market during the last few years has grown to be quite substantial. Though this could be a consequence of stricter regulation on banks (making it harder for corporations to obtain bank loans) it is much more likely to be a result of the low interest rate environment and a search for yield by investors opting to switch into, for example, fixed income funds. To some extent the growth in the corporate bond market is a welcome development since it offers non-financial corporations an alternative source of funding to borrowing from banks.

In finalising the outstanding elements of the post-crisis capital reforms for banks, it is important to ensure that the new capital requirements achieve their goal of stabilising the financial system and that they do not have an unintended structural impact on the EU banking system. Hence, we also want to stress the importance we place on monitoring the financial system to ensure that risks do not move to less resilient financial institutions to avoid regulation (i.e. regulatory arbitrage). If not properly monitored or regulated, the shifting of risks to outside the banking sector could make it more difficult for supervisors to identify and mitigate systemic risks.

However, given that the EU economy is so reliant on bank finance, initial and marginal increases in direct market financing by corporations will reasonably imply limited risk transfers. If market financing were to make up an increasingly large share of overall private sector funding, then an extension of the scope for supervision, including macro-prudential supervision, will become increasingly important.

For these reasons, we welcome the new regulation for less regulated shadow banking sectors such as the EU regulation enhancing transparency of securities financing transactions (SFTs) and FSB recommendations on shadow banking.

***Q15) Procyclicality:** EU rules have been put in place to make the financial system less procyclical and more stable through the business and credit cycle. Please indicate whether some rules have unintentionally increased the procyclicality of the financial system and how.*

Regarding the design of Solvency II, the risk-free interest rate term structure was designed to mitigate procyclical effects in financial markets. However, the design does in fact introduce new forms of procyclical effects as evidenced in Sweden and the Netherlands.

Sweden proposed regulation for insurance companies and pension funds based on the Solvency II model for the risk-free interest rate term structure, but received feedback from stakeholders in the consultation that led us to change the regulation[7,8].

The inherent problems have also been recognised in the Netherlands. The consultancy Cardano presented their analysis in a report (*Dangerous design flaws in the Ultimate Forward Rate: The impact on risk, stakeholders and hedging costs, Theo Kocken, Bart Oldenkamp and Joeri Potters Working paper, 13 July 2012*) and the Ministy of Social Affairs and Employment started an independent investigation of the matter: the UFR-commissie[9].

In order to understand the procyclical effects of a given model of the risk-free interest rate term structure, one should consider an insurance company with poor solvency trying to minimise the risk of breaching statutory regulatory requirements. In such a scenario, the insurer is subject to the market pricing movements of both its assets and liabilities. However, it *can* choose the composition of its asset portfolio such that any pricing changes have equal and opposite effects on its assets and liabilities, leaving its solvency unaffected. To do so, the insurer matches its assets and liabilities by investing in a replicating portfolio. Different models for the risk-free interest rate term structure imply different replicating portfolios.

The problem with the Solvency II type model is that it implies a replicating portfolio with extreme leverage and frequent rebalancing needs because the model for the risk-free interest rate term structure is designed to give a smooth curve at any given date. In essence, the model is designed to give an interest rate curve that “looks good” graphically at any given date, but this design gives rise to odd dynamics *in between dates*. The odd dynamics were not the intention of the model designers but rather an unintended side effect. The designers of the model thought that they were

[7] http://www.fi.se/Folder-EN/Startpage/Press/Press-releases/Listan/New-discount-rate-for-insurance/

[8] http://www.fi.se/Folder-EN/Startpage/Press/Press-releases/Listan/Second-limited-consultation-regarding-the-discount-rate/

[9] https://www.rijksoverheid.nl/documenten/rapporten/2013/10/11/advies-commissie-ufr

solving the problem of how to calculate figures for book keeping, while the model that they designed unfortunately has consequences that reach far beyond that.

We believe that a broader implementation in Europe of the alternative “Swedish model” noted above would serve to reduce these procyclical risks.