A N F Ö R A N D E

Datum 2021-09-02
Talare Karin Lundberg
Möte UBS Annual Nordic Financial Services Conference

FI dnr Ange dnr

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

Finansinspektionen's view on capital and distributions

SLIDE 1

Hopefully, we are now close to the end of a pandemic that has defined both our personal and professional lives for the last one and a half years. The extraordinary uncertainty around how pandemic-related restrictions would affect the economy and, in particular, the banking system has now washed away. It appears that the Swedish economy and the Swedish banks have been able to withstand the negative economic effects better than expected. Credit losses and profits are back to pre-pandemic levels. The results from this year's EBA stress tests show that the major Swedish banks have a sufficiently solid capital position looking forward. It is now time to pivot to an economic policy fit for a recovery, rather than for a downturn.

As you all know, we took several actions to release both capital and liquidity for the banks. The purpose of this was to ensure that the banks had the financial strength to meet the credit demand, which was expected to be high during the crisis. These measures are now rolled back.

In parallel, we also recommended that banks restrict their dividends. Finansinspektionen's recommendation that the banks' total dividends and buybacks should not exceed 25 per cent of their aggregate net earnings will expire as planned at the end of September. I am pleased to say that banks' compliance with the recommendation has been high, even where banks have delivered stable or in some cases improved profits throughout the pandemic. In my view, the banking community has shown strength in taking a societal responsibility during these times, preserving capital as well as supporting the credit supply. I expect the banks to continue on this path, continuing to support customers during the wind-down of fiscal policy measures and through the challenges that this may entail for them. Our intention is also to raise the countercyclical capital buffer again during this year. This is also something the banks has to take into account in their capital planning.

The recommendation to restrict dividends is not part of our ordinary toolbox. But the extreme uncertainty following the pandemic required extraordinary measures. In normal times, Finansinspektionen should not take a stand on banks' distribution. Finansinspektionen decides on the capital requirements, including Pillar 2 Guidance (P2G). That is our mandate. How much capital a bank wants to hold above this level, and therefore how much capital it wishes to distribute to its shareholders, is up to the banks owners.

SLIDE 2

For several years now, capital regulation has undergone frequent changes. Inevitably, this introduces uncertainty as to rules of the game. And neither the market nor we supervisors like uncertainty. And this is set to continue in the near term. Even though we are still implementing the final pieces from the banking package, we now await a new large regulatory proposal from the Commission. This proposal will cover the last pieces to finalise the Basel 3 Accord including the Basel floors and a changed standardised approach for credit risk.

Despite all these changes, the two fundamental principles behind Finansinspektionen's approach to capital regulation have been more or less the same ever since we implemented CRD 2 in 2014. And they will continue to be so looking forward. We listed these principles in our capital memo last year, outlining our implementation of the banking package, which has now come into force. They have been our compass when deciding on the current design of the buffer and Pillar 2 framework, and they guide us also looking forward, discussing the development of new regulation. The first principle is:

1) A bank should be able to use its capital to absorb losses *in going concern* so that the capital is there to mitigate resolution or liquidation.

Self-evident one might think, but looking at how the capital requirement has previously been designed, this aspect has not always been considered. To achieve this in practice, we have chosen an approach with relatively high buffers including Pillar 2 guidance in both the risk-based requirement and the leverage requirement. We have also made sure that the buffers are all fully covered by CET1.

We also try to speak a lot, as I do today, about how buffers are truly there to be used. This in order for market participants to accept and understand that banks are allowed to dig into buffers temporarily, and if their business model is fundamentally sound they will get time to rebuild their capital base.

Our active use of the counter-cyclical capital buffer should be viewed in this light. Before the pandemic hit, we had one of the world's highest counter cyclical buffer rates. Buffer capital needs to be accumulated during good times. But we also did not hesitate to take it down to zero, when needed. This is a concrete example of how this principle guides us. Now, when the economy is recovering, the counter-cyclical buffer will be raised again.

As we stated in a memo this spring, FI will henceforth strive to keep the countercyclical capital buffer at a positive neutral level. The countercyclical capital buffer that we will strive for during normal periods is 2 per cent. This creates room for lowering the buffer requirement during a greater interval of the financial cycle, i.e., also in cases when a shock occurs without having been preceded by a period of markedly rising systemic risks. We also state that in order for the buffer capital to be used by the banks, it is important not to raise the buffer requirement too early or quickly after a crisis. The timing for when to start raising the buffer depends on the banks' capital situations and their ability to handle a higher capital requirement without negatively affecting the credit supply. This time, we will start raising the buffer again quite soon after the crisis, but this is because of the unexpectedly mild effects it has had on the Swedish banking system. This should not be taken as a sign that a quick increase of the buffer rate will always be the case. Had the banks' capital been hit harder, our response would have been different.

The second principle is that:

2) The capital requirements should be sensitive to both idiosyncratic and systemic risks.

We believe incentives matter. And the capital framework brings quite forceful incentives to banks. Therefore, as far as we can measure risk in a reliable manner, low risk exposures should have low capital requirements and vice versa. Evidence has shown, however, that measuring risks is a delicate matter. Banks themselves have incentives to underestimate risk weights and individual banks clearly cannot be expected to assess systemic risks. Therefore, this principle is often difficult to fully meet in practice. It is nonetheless very important to keep in mind.

In the capital memo from last year, we also stated that there is no intention from our side to materially change the overall level of capital required in the Swedish banking system. This is still also the case given our current risk assessment. Having said that, I should probably point out that new regulation and new or changing business models may still lead to material changes in the capital requirement in specific cases.

SLIDE 3

One regulatory change that can have a large impact on individual banks is the introduction of the leverage ratio requirement. This is especially the case when combined with our fundamental principle that the capital base of a bank must include sufficient buffers that can actually be used to keep the bank in business throughout tough times. The leverage ratio is a minimum capital requirement, thus there is no Pillar 1 buffer framework for it as there is in the risk-based capital regime. When assessing how to implement the banking package in the

Swedish environment, this meant that the fundamental principles important to us, large usable buffers and risk sensitivity, came into conflict.

In this example, looking first without Pillar 2 guidance, what you see is that the minimum leverage ratio requirement eats up a large part of the Pillar 1 buffer. This gives us much less time to find a going-concern solution. Still, given that there are no buffer requirements on top of the leverage ratio, apart from the G-SII buffer, which is not applicable to any Swedish bank, the risk-weighted capital requirement is the binding capital restriction. This means that the risk sensitivity in the capital regime is still there.

Now look what happens when we add the Pillar 2 guidance. P2G overlaps the capital conservation buffer in the risk-weighted regime, in this example adding a smaller amount. Since there are no overlapping buffers on top of the leverage ratio, the P2G for the leverage ratio adds a bigger amount. This makes the non-risk sensitive leverage ratio the binding capital restriction. As such, this goes against our principle of trying to achieve sound capital incentives, but it supports the principle of having sufficiently large usable buffers on top of the minimum requirement. At the end of the day, we decided that the principle of a sufficiently large usable buffer was even more important than maintaining the risk-sensitive capital requirement as the binding restriction. The situation that this picture illustrates – that the leverage ratio requirement including P2G will be the binding restriction – is inherently more common now with the counter-cyclical buffer set to zero than it will be when it is raised again.

This picture of how the risk-based and the leverage ratio capital requirements interact get even more complicated when taking into account that the leverage ratio minimum requirement can be met with Tier 1 capital, whereas all buffers must be met with CET1.

When you have parallel capital requirements, that in turn may be covered with different kinds of capital, the analysis of what could happen in a financially stressed situation inevitably becomes highly complicated. We believe that adding P2G on top of the leverage ratio will increase financial stability. It gives us flexibility and time to manage a bank in financial stress. This does not mean that we would necessarily favour adding Pillar 1 buffers to the leverage ratio. The standardised design of these as well as the automatic restriction tied to them requires a different analysis of the pros and cons.

Speaking of parallel requirements and buffer usability, it is also worth mentioning the minimum requirement on eligible liabilities (MREL). Setting the last details of the MREL framework is an important milestone for the resolvability of banks. But this requirement is also linked to the discussion of buffer usability. The MREL is based on the risk-based requirement and the leverage ratio requirement and can also be fulfilled with the same capital base. In practice, the MREL therefore can have an impact on the usability of the capital buffers in going concern. It is important to understand and consider this aspect when applying this requirement. In our response to the Swedish National Debt Office consultation on their application of the rules, this is an aspect we will highlight.

Just to add yet another layer of complexity when analysing buffer usability and at which point a bank is failing or likely to fail, I also need to point out that the level of the minimum capital requirement is not a regulatory cliff. The regulatory framework specifies that FI's analysis shall be forward looking. Accordingly, FI is able to make the assessment that a bank has failed or is likely to fail even though the measured capital exceeds the minimum requirement. However, for the same reason, FI is able to make the assessment that a bank which is in breach of the minimum requirement has not failed if, following recovery measures, there are reasonable chances of it complying with the requirements within a reasonable time. The point of failure may therefore be both above and below the minimum requirement. In other words, the forward-looking prospects for the bank's business model may be just as important as the banks' capital standing when assessing if the bank is failing or likely to fail.

SLIDE 4

Let me now tell you a bit more about our implementation of Pillar 2-guidance. First of all, we like Pillar 2-guidance. We can use it to strengthen the fulfilment of both fundamental principles of usable buffer capital and risk sensitivity. Before the implementation of the banking package, we used what we called the capital-planning buffer. Pillar 2-guidance is in many ways very similar to the old capital planning buffer, but is has a clearer and more solid legal basis and is also based on EU-harmonised regulation. Something we highly welcome. Also, with the new regulation, we must now formally decide on the P2R, which means that the MDA trigger level now includes the P2R. This makes it even more necessary to have a buffer that is fully usable without any automatic restrictions tied to it.

SLIDE 5

At the end of May this year, we published our P2G framework. The basis for this framework is firstly, of course, the European and Swedish legislation. Secondly, it is also based on the experience we have built up at Finansinspektionen from many years working with the EBA stress tests, developing our own macro-scenario based stress tests, and the sensitivity-based stress test we have used to determine the capital-planning buffer.

We will decide on the P2G in two steps. First, we will conduct the sensitivity-based stress test for all banks. For the larger banks where we also conduct the EBA stress test and our own macro based benchmarking test, we will also take these results into account. In the second step, we will conduct an expert assessment of the outcome of the stress tests, adding other quantitative or qualitative aspects when deemed necessary. We decide on a Pillar 2 guidance both for the risk-weighted capital requirement and for the leverage ratio requirement. The basis for the decision – the stress tests – are the same. The main difference is that there is no risk-weight migration in the leverage ratio stress test. And, of course, as you saw in the example earlier, for the leverage ratio there is no capital conservation buffer that is overlapping, rather the full amount is added as P2G.

Before leaving the subject of P2G, let me say a few words about transparency. We believe in full transparency of the capital requirement, and that includes P2G. I am sure you are aware that not all of my international colleagues share this view. Many of those who argue that P2G should not be disclosed believe that the disclosure of P2G will harm the usability of this buffer. That the banks will not be prepared to dig into the buffer, if disclosed, because of the market reactions that could result. We have made the assessment that market uncertainty about the rules of the game will cause bigger issues. But this transparency also require us as supervisors to explain to the market that banks with sound long-term business models are allowed to make use of P2G as well as other buffers when in a temporary crisis. This is the whole point of the buffers.

P2G is decided upon on as part of the SREP. Our SREP process for the larger banks, i.e. the banks in the supervisory categories 1 and 2, is close to being finished. The banks received the preliminary decision from us at the end of June to comment on, and the final decision will be taken end September. Just as we have done every quarter since 2014, we will publish a short report on the total capital requirement for the larger banks. The first report with the new requirements will be published in November, based on Q3 numbers.

SLIDE 6

As my final point, I wanted to say a few words about the finalisation of Basel 3 and the introduction of these last changes in the European and Swedish regulation. As you probably know, we expect the Commission to present its legislative proposal this autumn.

A robust, global level playing field is important for financial stability, even in a small country such as Sweden. We all want to avoid the situation that we had before the first Basel accord, where banks could compete globally with low solvency standards. Therefore, we think that the agreement in 2017 in the Basel committee around the finalisation of Basel 3 should be preserved and respected in the national implementation of the accord. Both in the letter and in spirit. Firstly, the output floor should be implemented as agreed in Basel, with all risk-based capital measures and buffers calculated based on one single risk exposure, thus avoiding complex parallel requirements based on different sets of REA. Secondly, a general watering down of the accord through different EU

specific deviations must be avoided. This goes in particular for the new standardised approach for credit risk.
As to the Swedish implementation of these up-coming rules, it is too early to go into much detail. But what I can say is this: The same fundamental principles that have been the basis for the current implementation will continue to guide us going forward. Moreover, since we have been proactive in using the current tools available to us, such as risk weight floors for both mortgages and commercial real estate, the potential effect of the output floor is not nearly as large as it would otherwise have been.

Thank you for listening.