

Decision Memorandum



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Updated approach to assessing Pillar 2 guidance for Swedish banks

Summary

As a result of the implementation of the EU's new capital adequacy regulations in Sweden in 2020 and 2021, Finansinspektionen (FI) must establish a so-called Pillar 2 guidance for each undertaking (hereafter bank or institution) subject to the Supervision Act. In this memorandum, we describe the updated approach that FI will apply starting on 31 May 2023 to assess Swedish banks' Pillar 2 guidance.

In connection with a supervisory review and evaluation process (SREP) of an institution, FI must assess what constitutes an appropriate level for the bank's own funds in order to, for example, cover risks and manage stressed scenarios that are not covered by the minimum requirements, the additional own fund requirements (Pillar 2 requirements) and the combined buffer requirement or the leverage ratio buffer requirement. If we determine that a bank needs more capital, we communicate this to the bank via a Pillar 2 guidance.

FI starts with a sensitivity-based stress test that estimates how much the bank's capital ratio would be impacted when applying a number of assumptions and methodology choices. In the first step, the stress test is standardised. However, it may be relevant to expose the banks to different types of stress in order for the stress test to be pertinent to the business model in question. In a second step, FI therefore makes any institution-specific adjustments necessary where these are possible to quantify. The outcome from the stress test is then rounded off into buckets. FI then considers other qualitative grounds for assessment and determines the final level of the guidance based on an overall assessment.

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1 Background and introduction

1.1 Background and purpose of Pillar 2 guidance

The regulatory framework for the Swedish banks' capital requirements, was amended by the EU's banking reform package (the banking package), which was introduced in Sweden in 2020 and 2021.¹ The banking package was the result of global negotiations within the cooperation with the Basel Committee for Banking Supervision (the Basel Committee) and the Financial Stability Board (FSB).

The banking package changed the EU's capital adequacy regulations primarily by amending the Capital Requirements Regulation (CRR)² and the Capital Requirements Directive (CRD).³ The CRR is directly applicable in all member states, and the new rules have primarily been applied since 28 June 2021. The amendments to the CRD have been implemented into Swedish law primarily through the Credit Institutions and Securities Companies (Special Supervision) Act (2014:968) (the Supervision Act) and the Capital Buffers Act (2014:966) (the Buffers Act). These amendments entered into force on 29 December 2020.

The amendments introduced an obligation for FI to communicate to banks what it considers a suitable level for each bank's own funds in order, for example, to cover risks and manage stressed scenarios not covered by the minimum requirements, the additional own fund requirements (Pillar 2 requirements) and the combined buffer requirement or the leverage ratio buffer requirement. The aim of the Pillar 2 guidance, thus, is for each bank to have sufficient own funds to cover risks or aspects of risks that are not covered by other requirements and be able to absorb losses during a financial shock. This creates a threshold before breaches to the various buffer requirements require automatic dividend restrictions.⁴

² Regulation (EU) No 575/2013 of the European Parliament and of the Council of 26 June 2013 on prudential requirements for credit institutions and amending Regulation (EU) No 648/2012 (Capital Requirements Regulation).

³ 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, amending Directive 2002/87/EC and repealing Directives 2006/48/EC and 2006/49/EC (Capital Requirements Directive).

⁴ No Swedish bank is subject to a leverage ratio buffer in Pillar 1.

1.2 Introduction to this memorandum

In order to achieve transparency, equal treatment and predictability, FI developed an approach in 2021 to determine the size of the Pillar 2 guidance. The method that we describe in this memorandum is a further development of the previous approach. The implemented improvements and adjustments are based on the lessons FI learned during the two years the approach has been applied.

Both the stress test method and the process described in this memorandum will probably continue to be developed over time. If, in the future, FI intends to apply additional steps to determine the Pillar 2 guidance or change the existing method in such a way that the outcome will be materially impacted, and if it is relevant for several banks, FI will continue to submit such supplements for separate consultation.

The firms impacted by this memorandum are credit institutions pursuant to the definition set out in Chapter 1, section 2, point 7 of the Credit Institutions and Securities Companies (Special Supervision) Act (2014:968) (the Supervision Act). In the memorandum, these firms are referred to as “banks” or “institutions”.

1.3 Legal basis

Chapter 2, section 1c of the Supervision Act specifies that Finansinspektionen, in conjunction with a review and evaluation of an institution, must determine appropriate own fund levels for the institution. FI must notify the institution about the difference between these levels and the own funds requirements pursuant to the Capital Requirements Regulation, the Supervision Act (Pillar 2 requirements) and the Capital Buffers Act.

In other words, the Pillar 2 guidance is the difference between the above-mentioned requirements and the own funds level that FI judges to be appropriate.

As set out in the provision, the Pillar 2 guidance is determined in conjunction with a supervisory review and evaluation process (SREP) for the institution. An SREP is carried out in accordance with the regulations relating thereto set out in the Capital Requirement Directive.⁵ However,

⁵ See section 9 of the Special Supervision and Capital Buffers Ordinance (2014:993).

there is no regulation specifying how FI should carry out its assessment of which own funds levels are appropriate for an institution. Relevant text set out in the preparatory works for Chapter 2, section 1 of the Supervision Act⁶ specifies that when determining a Pillar 2 guidance the results of stress tests must be considered, as well as the evaluation of other risks to which the institution is or may be exposed. Furthermore, a Pillar 2 guidance must be institution specific, which means that only the risks in the individual institution in question may serve as the basis for a guidance. The guidance may cover risks that are subject to decisions on additional own funds requirements only to the extent the guidance covers aspects of these risks that are not already covered by the requirement. Given the absence of more detailed regulation on *how* the guidance is to be determined, FI has been given considerable freedom in designing its supervisory assessments.

The European Banking Authority (EBA) has issued guidelines on common procedures and methodologies for the supervisory review and evaluation (the EBA's guidelines) that should be incorporated in an appropriate manner into the competent authorities' supervisory practices.⁷ The guidelines also contain instructions for how the Pillar 2 guidance can be used to manage the quantitative results of stress tests.⁸ FI has considered the EBA's guidelines when developing the approach and will also consider them when applying the method.

1.4 Scope

A Pillar 2 guidance must be determined in conjunction with a supervisory review and evaluation process for the institution. As a starting point, how often FI performs an SREP depends on the supervision category to which the institution is assigned.

FI annually conducts a supervision categorisation in accordance with the EBA's guidelines on the supervisory review and evaluation process. The categorisation includes Swedish credit institutions and foreign credit institutions' Swedish branches and is performed in part to show how FI

⁶ Bill 2020/21:36, p. 113 (and Article 104(b)(i) of the Capital Requirements Directive on which Chapter 2, section 1 of the Supervision Act is based).

⁷ Guidelines on common procedures and methodologies for the supervisory review and evaluation (SREP) process. EBA/GL/2022/03 of 18 March 2022.

⁸ Section 7.7.1 of the EBA's guidelines.

applies proportionality in its supervision. The supervision categorisation is adopted in the autumn every year and is published on FI's website.⁹

One of the aims of the categorisation is to provide FI with a basis on which to decide the frequency and scope of each bank's SREP, in conjunction with which Finansinspektionen will assess the own funds levels that are appropriate for the institution. Where a Pillar 2 guidance is deemed necessary, the institution will be informed about it when the capital and liquidity requirements are decided and announced following the completed SREP.

Generally, FI will review the assessment

- annually for banks in Supervision Category 1
- at least every other year for banks in Supervision Category 2.

For banks in Supervision Categories 3 or 4, FI conducts an SREP more infrequently as long as the risk profile does not justify more frequent monitoring. For these banks, FI has the ambition to conduct an SREP approximately every three years. FI may deviate from the stated frequency if there are grounds to do so.

The guidance FI communicates to a bank applies until we communicate a new guidance to the bank.

1.5 Preparation of the matter

In the consultation memorandum on FI's application of the new capital requirements for Swedish banks that was published on 25 September 2020, FI announced its intention to develop an approach to assess the Pillar 2 guidance and submit a proposal in the spring of 2021. On 15 February 2021, FI submitted a proposal for a general approach to assess the size of the Pillar

⁹ For more information on FI's method for the categorisation itself, see the memorandum "Finansinspektionens kategorisering av kreditinstitut och filialer för den löpande tillsynen" (FI Ref. 22-18982), September 2022, FI.

For more information about the current categorisation, see the memorandum "Tillsynskategorisering av svenska kreditinstitut och utländska kreditinstituts svenska filialer för 2023" (FI Ref. 22-19478), September 2022, FI. Available in Swedish.

2 guidance for Swedish banks.¹⁰ This was followed by a decision memorandum that was published on 31 May 2021.¹¹

On 4 April 2023, FI submitted a proposal for an updated approach to assess the Pillar 2 guidance for Swedish banks.¹² The proposal was sent to twelve consultation bodies and also published on FI's website. The final date for responses was 2 May 2023. The following organisations submitted responses: *the Association of Swedish Finance Houses, the Swedish Investment Fund Association, Klarna bank AB (Klarna), the Swedish Competition Authority, the Swedish National Debt Office (SNDO), the Swedish Savings Banks Association, the Swedish Bankers' Association, Sveriges Riksbank (the Riksbank) and the Swedish Fintech Association*. The Swedish Investment Fund Association, the Swedish Competition Authority, and SNDO had no comments on the proposals in the consultation memorandum.

FI has considered all submitted consultation responses, including those that we do not present in the memorandum.

2 Approach to assess an appropriate Pillar 2 guidance

In this section, FI describes the approach we intend to use to assess an appropriate Pillar 2 guidance for affected banks. The section starts with a description of the overarching approach and the process. It then continues with a description of the main stress test method and how the results from the stress test are broken down into buckets. The section concludes with a description of other grounds for assessment that can serve as a basis for the guidance.

¹⁰ See consultation memorandum “Övergripande ansats för att bedöma pelare 2-vägledningen för svenska banker” (FI Ref. 20-28036), FI, 15 February 2021. Available in Swedish.

¹¹ See the consultation memorandum “Övergripande ansats för att bedöma pelare 2-vägledningen för svenska banker” (FI Ref. 20-28036), FI, 31 May 2021. Available in Swedish.

¹² See the consultation memorandum “Ny övergripande ansats för att bedöma pelare 2-vägledningen för svenska banker” (FI Ref. 23-9797), FI, 4 February 2023. Available in Swedish.

2.1 Introduction

In the memorandum “Nya kapitalkrav för svenska banker” (New capital requirements for Swedish banks) that was published in November 2020 FI describes how the new capital requirements will be applied. The memorandum also contains a number of basic positions related to the application and design of the Pillar 2 guidance. Among others, below.¹³

For each bank FI will assess:

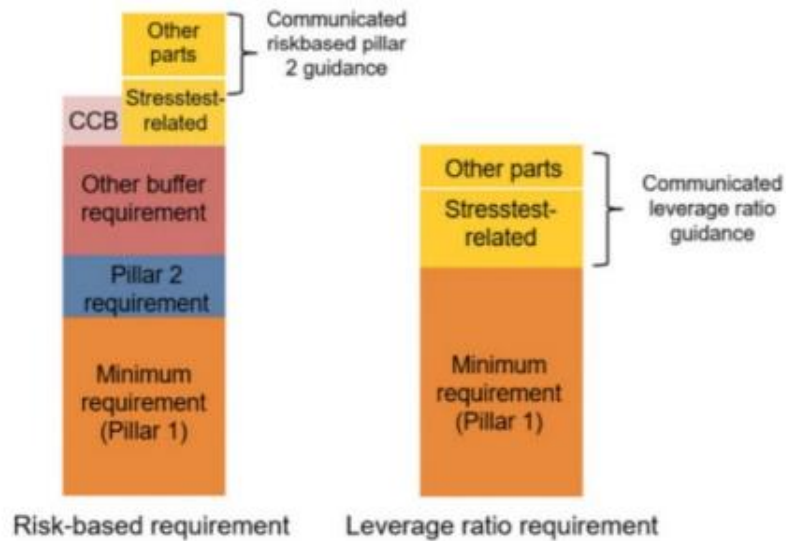
- a risk-based Pillar 2 guidance expressed as a percent of the risk-weighted assets, and
- a leverage ratio guidance expressed as a per cent of the leverage ratio exposure amount.

The capital need that is determined through the capital conservation buffer should be deducted from the risk-based Pillar 2 guidance. This means that the risk-based Pillar 2 guidance communicated to the bank specifies the level that exceeds the capital conservation buffer. A corresponding deduction is not made for the leverage ratio guidance since there is no equivalent of the capital conservation buffer in the leverage ratio rules. Diagram 1 provides a schematic presentation of how the guidance relates to the other components of the capital requirement.

The risk-based Pillar 2 guidance and the leverage ratio guidance will only be able to be met using common equity Tier 1 capital.

¹³ For more information, see the memorandum “Nya kapitalkrav för svenska banker” (FI Ref. 20-20990), November 2020, FI. A translation into English is available at www.fi.se.

Diagram 1. General design of the guidances



Source: FI.

Note: The capital conservation buffer has been abbreviated to CCB. The size of the different parts of the diagram and the bars' relation to one another is only illustrative.

2.2 Overarching approach and process

The process for assessing the size of an appropriate Pillar 2 guidance occurs primarily through the four steps described below:

1. Standardised stress test
2. Quantitative adjustment of the stress test
3. Placement into buckets
4. Other grounds for assessment and determination of guidance

A more detailed description of these steps is available in the following sections.

2.3 Main stress test methodology

FI's position: FI intends to primarily rely on a sensitivity-based stress test. The outcomes will be calculated in risk-weighted terms and leverage ratio terms, where changes in the risk-weighted exposure amounts only affect the risk-based calculations. The method will be applied to all banks, but it may be relevant to expose the banks to different types of stress to a certain extent, for example for the stress to be relevant for the business model in question.

2.3.1 Sensitivity-based stress test

FI intends to use a sensitivity-based stress test as its primary method to assess an appropriate Pillar 2 guidance. The calculation refers to a three-year period and is based on the bank's most recently reported balance sheet and the three most recent income statements.

2.3.1.1 Standardised stress test

The method is constructed by FI making assumptions regarding changes to various risk parameters, for example banks' credit losses, net interest income, net commission income, net financial income, etc. The method estimates the decrease in the banks' CET 1 capital due to the stress, in both risk-weighted terms and leverage ratio terms. In the first step, the stress test is completely standardised in the sense that all banks are subject to the same calibration and assumptions.

See Appendix 1 and 2 for more details regarding the stress test's design and the calibration memorandum that FI intends to publish every year.

2.3.1.2 Quantitative adjustment of the stress test

However, it may be relevant to expose the banks to somewhat different types of stress in order for the stress test to be pertinent to the individual institution. In the second step of the stress test, FI therefore can make institution-specific adjustments to the stress test where it is possible to quantify such adjustments.

The adjustments can be made to both a group of institutions and individual institutions. For example, the adjustments can be based on the institution's specific business model, costs or income that are one-off in nature or potential risk-mitigation measures that impact the income statement. We may also make adjustments where we see that the standardised stress test generates an unreasonable outcome. Or if FI makes the assessment that the most recent reported income statement and balance sheet are not representative.

In practice, this is an iterative process where adjustments may be made several times.

2.3.2 Feedback received

2.3.2.1 Feedback on the method in the main text

The Swedish Bankers' Association takes the position that the approach FI describes is not sufficiently clear and transparent. Furthermore, they take the position that the primary stress test method and the qualitative grounds for assessment are not sufficiently described for each bank to be able to estimate the effect for each bank, which creates poorer conditions for the banks in their internal capital planning. The Swedish Bankers' Association also would like to see a clarification or description of what constitutes one-off costs and risk-mitigation measures.

The Association of Swedish Finance Houses takes the position that it is not possible to estimate the effect for an individual institution using the description in the memorandum and it is not clear how the various methods and grounds for assessment will be applied together. It also underlines that FI must ensure that the assessment will be institution specific. The Association of Swedish Finance Houses also takes the position that the lack of criteria or more detailed definitions of what constitutes one-off costs or income will make it difficult to predict Finansinspektionen's assessment.

The Swedish Savings Banks Association also emphasises the importance of the capital requirements being institution specific and takes the position that the outcome of the proposed new approach cannot serve as a basis for a guidance without performing a thorough and qualitative assessment of institution-specific conditions in addition to the outcome of the proposed approach.

The Swedish Fintech Association is positive to FI clarifying the process for determining the Pillar 2 guidance. However, it takes the position that there are still ambiguities that make it difficult to get an overview of the effects of the proposal, which makes capital planning more difficult for its members. It also takes the position that the stress test method that FI uses is not sufficiently adjusted for companies with business models, strategies and methods that differ from traditional large banks. It furthermore states that FI's clarification of the possibility to make quantitative adjustments to the stress test is positive, but that it would like to see additional clarifications on how FI intends to make these adjustments.

Klarna welcomes FI's clarifications related to the process but takes the position that it is important to use a stress test method that already in the

first step is adjusted to the company's specific business model and risk profile. There is a risk that the method of making adjustments in a later step will result in the need to make large adjustments in order for the outcome to be reasonable. Klarna also asserts that the procedure is somewhat arbitrary with regard to which adjustments should be made since this is not set out in any method.

The Riksbank has no objections to the main tenets of Finansinspektionen's proposal and takes the position that it is reasonable for FI to regularly review the methodology for assessing the Pillar 2 guidance for Swedish banks in order to benefit from lessons learned.

2.3.2.2 Feedback on the content of the appendices

The Swedish Bankers' Association takes the position that it is not clear how the described standardised calculations can be said to constitute institution-specific stress. The Swedish Bankers' Association also questions if it is reasonable that Finansinspektionen, in Appendix 2, focuses on a specific risk and takes the position that a corresponding detailed description should be made for all risk parameters included in the stress test.

The Association of Swedish Finance Houses takes the position that it should be clear what will be stressed but also how the stress will be applied and that it is unclear how standard templates can be considered institution specific. The Association also raises feedback regarding the ambiguity related to stress of leasing operations and emphasises that the capital requirements for the leasing operations are already high in Pillar 1. The Association also takes the position that the description of other relevant risks can be as detailed as the description of the stress of pension items.

The Swedish Fintech Association questions a standardised method since the outcome from recent years has shown clearly that the method requires adjustments to generate outcomes that are reasonable for each institution.

Klarna takes the position that a starting point of a three-year average for earnings is not representative for some companies. Therefore, FI should consider the use of a dynamic balance sheet or at least allow room for conducting a qualitative assessment of what is a representative starting point in the stress test.

2.3.3 FI's comments on the general feedback

FI notes that several of the consultation bodies would like us to present parts of the approach and grounds for assessment in more detail. *The Swedish Bankers' Association* and *the Association of Swedish Finance Houses* would like to see, for example, clarifications or descriptions of what constitutes one-off costs. *The Swedish Fintech Association* would also like to see further clarification about how FI intends to make the quantitative adjustments.

FI's point of departure is that all costs are included in the stress test. However, FI can choose to exclude major costs that are obviously one-off in nature that can be considered to result in a non-representative income statement. In terms of any other quantitative adjustments, it is not possible to list or define them in advance since they are situation-based or institution-specific adjustments.

Several consultation bodies also point to the importance of the assessment being institution specific. *The Swedish Fintech Association* also believes that FI has further standardised the stress test compared to the previous approach. We would like to clarify here that FI also used a standardised stress test before, and that we then made institution-specific adjustments to it. However, we have chosen to clarify this procedural breakdown more than we did in the previous memorandum.

With regard to the actual term *institution-specific*, FI would like to assert that in this context this term entails that it is only the risks for the individual institution that serve as a basis for a Pillar 2 guidance and not, as before, also the risks to which the institution exposes the financial system. The fact that a Pillar 2 guidance is to be institution specific does not further rule out FI using standardised stress tests with static balance sheet assumptions as long as it is possible to make quantitative adjustments and changes based on qualitative analysis to the results given the individual institution's specific situation. In other words, it is not necessary for each individual step in the assessment to be adjusted to the individual institution, but rather it is the end result that must be institution specific. This assertion was also supported by a ruling by the administrative court on 1 December 2022.¹⁴ We would also like to emphasise that the method, which uses stress tests based on different forms of the lowest common denominator, is focused on promoting predictability, equal treatment and legal soundness in its application.

¹⁴ Ruling by the Administrative Court of Stockholm on 1 December 2022 in Case 30357-21.

2.4 Placement into buckets

FI's position: The method estimates the reduction in the banks' common equity Tier 1 capital ratios as a result of the stress, and based on this outcome FI will assign each bank to a bucket on a scale of rounded-off percentages. The size of the buckets will differ between the risk-based Pillar 2 guidance and the leverage ratio guidance.

2.4.1 Buckets for the risk-based guidance

Table 1 and Diagram 2 show FI's intended buckets for the banks. Because the capital conservation buffer of 2.5 per cent is to be deducted from the risk-based guidance, the levels are shown after this deduction.

The outcome of the stress test is broken down into six buckets. The steps up to 1.0 per cent are 0.5 percentage points, and the step up to 2.0 per cent is 1.0 percentage point. The steps thereafter up to 5.0 per cent are 1.5 percentage points.

Table 1. Buckets for the risk-based guidance

Per cent

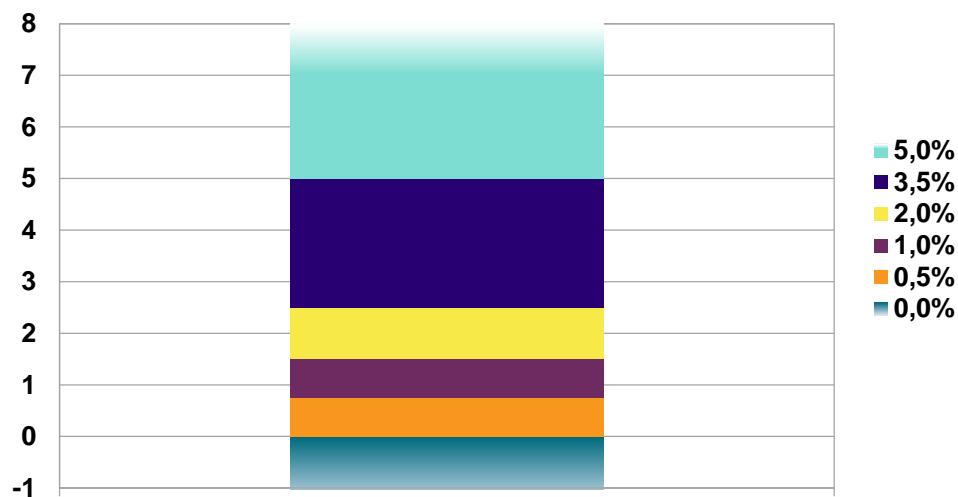
Bucket thresholds – outcome from the stress test after the deducted CCoB	Corresponding guidance	Label
<= 0	0.0	Very low capital volatility
(0: 0.75]	0.5	Low capital volatility
(0.75: 1.5]	1.0	Medium-to-low capital volatility
(1.5: 2.5]	2.0	Medium-to-high capital volatility
(2.5: 5]	3.5	High capital volatility
>5.0	5.0	Very high capital volatility

Source: FI.

Note: Capital conservation buffer (CCoB) of 2.5% has been deducted. The level of guidance shown in the table is not necessarily the final guidance. FI may use other assessment factors to adjust the level generated by the stress test. However, the point of departure is that a guidance will only be announced with the percentages stated in the table. For example, if FI sees a reason for a higher guidance than 0.5, the next level that is applicable is 1.0 and not a value in between the two.

Diagram 2. Buckets for the risk-based guidance

Per cent

Capital ratio depletion

Source: FI.

Note: The graph shows the decrease in CET 1 capital in relation to risk-weighted assets following deductions for the capital conservation buffer of 2.5 per cent. If the decrease in the capital ratio fits within the capital conservation buffer, or given a positive outcome under stress, the bank is assigned the bucket of 0%.

2.4.1.1 Feedback received

The Swedish Bankers' Association supports the proposal to round off the risk-based guidance towards the bucket's mid-point. However, it takes the position that the proposed buckets where the stress test shows low capital volatility are too wide, which gives rise to large threshold effects. The Swedish Bankers' Association therefore proposes the introduction of a bucket threshold of 0.25 per cent between very low capital volatility (0 per cent) and low capital volatility (0.5 per cent).

The Association of Swedish Finance Houses welcomes and supports the proposal to round off to the bucket's mid-point.

The Swedish Fintech Association and *Klarna* are positive to FI's proposed broader bucket and rounding off to the mid-point of the bucket.

2.4.1.2 Reasons for FI's position

Compared to the previous method, the buckets are slightly fewer in number and wider. The figures in each bucket are rounded to the middle of the bucket instead of upward.

The guidance should be adjusted to the risk level in the bank's strategy and business model but preferably not impacted to any great extent by temporary economic cycle factors. Some banks have relatively stable results over time, while the results of other banks vary more considerably from year to year. Since the stress test approach is based on last year's results, the outcome of the stress test can vary, which means that institutions may end up in higher or lower buckets from one year to the next without there being a change in the bank's actual risk level. Broader buckets reduce this effect.

The changes also aim to achieve more stable guidances over time and more comparable results for banks in each supervision category. This is because the frequency of the supervisory review and evaluation process varies depending on the supervision category to which the bank belongs. Broader buckets require greater changes in the stress test outcome for a bank to change bucket from one year to the next, which means that the guidance is more stable over time. This is particularly relevant for the institutions where an SREP occurs annually and thus receives updated guidances more often. Due to the broader buckets, the results of the stress test are also more comparable for the institutions where an SREP occurs more infrequently. The impact on these banks from the above-mentioned cyclical characteristics of the stress test approach can vary. Broader buckets mean that individual years, which can be good or bad, do not have as much of an impact on the final results.

Buckets that are too narrow can result in outcomes that are too volatile at the same time as buckets that are too wide can give rise to unjustifiably large threshold effects. FI takes the position that the steps set out in Table 1 and Diagram 2 are well-balanced.

The changes also reflect that the result of the stress test is FI's best assessment of what could happen under hypothetical stressed conditions, but it is not an exact prediction of future outcomes. Based on the outcome of the stress test, it is possible to identify which banks are more impacted or less impacted by the stressed situation. In other words, the stress test is good at ranking. At the same time, the stress test, combined with FI's assessment, must result in a Pillar 2 guidance expressed in exact terms. The aim of the labels in Table 1 is to reflect this in another way.

2.4.2 Buckets for leverage ratio guidance

Table 2 and Diagram 3 illustrate the buckets to which FI intends to allocate the banks based on their leverage ratio.

The outcome of the stress test is broken down into six buckets. The lowest level is 0.15 per cent, followed by 0.5 per cent. Thereafter the steps are 0.5 percentage points up to 1.5 per cent, and then 0.75 percentage points up to the highest level of 3.0 per cent.

Table 2. Buckets for leverage ratio guidance

Per cent

Bucket thresholds – outcome from the stress test	Corresponding guidance	Label
<= 0.30]	0.15	Very low capital volatility
(0.30: 1.0]	0.50	Low capital volatility
(1.0: 1.5]	1.00	Medium-to-low capital volatility
(1.5: 2.25]	1.50	Medium-to-high capital volatility
(2.25: 3.0]	2.25	High capital volatility
>3.0	3.00	Very high capital volatility

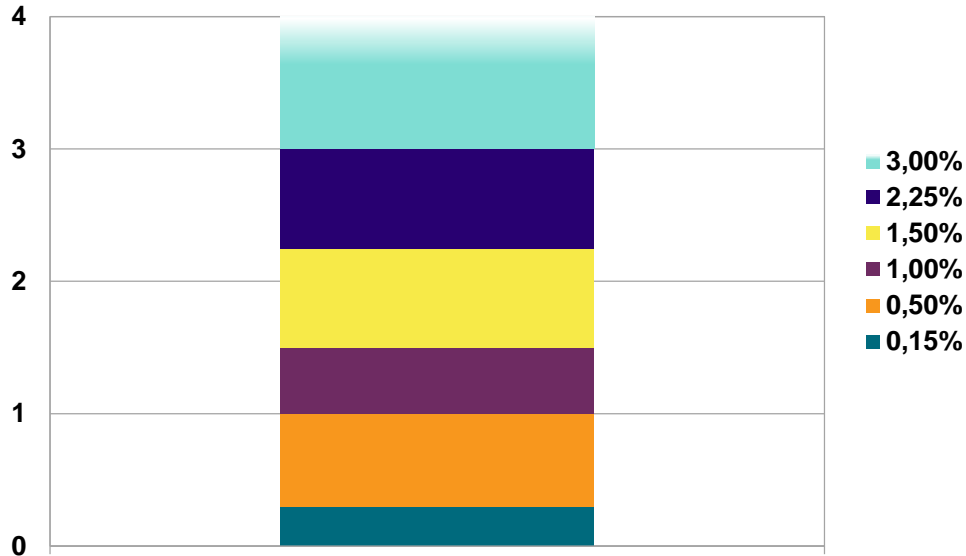
Source: FI.

Note: The level of guidance shown in the table is not necessarily the final guidance. FI may use other assessment factors to adjust the level generated by the stress test. However, the point of departure is that a guidance will only be announced with the percentages stated in the table. For example, if FI sees a reason for a higher guidance than 0.5, the next level that is applicable is 1.0 and not a value in between the two.

Diagram 3. Buckets for the leverage ratio guidance

Per cent

Capital ratio depletion



Source: FI.

Note: The graph shows the decrease in Tier 1 capital as a percentage of the leverage ratio exposure. Given a positive outcome under stress, the bank is allocated to the lowest bucket of 0.15%.

2.4.2.1 Feedback received

The Swedish Bankers' Association supports the proposal to round the leverage ratio guidance downwards. However, it notes that in the table the numbers have not always been rounded downwards, which has a negative impact on banks with low risk. The Swedish Bankers' Association also takes the position that the buckets are too wide. It proposes therefore the introduction of an additional bucket of 0 per cent and that all buckets be rounded downward.

The Association of Swedish Finance Houses supports the proposal to round downward. It notes, however, that the rounding in the table does not agree with this proposal. It also takes the position that the table should be adjusted so that institutions with low risk do not receive unjustified unfavourable treatment and that FI should consider introducing an additional level to avoid threshold effects.

2.4.2.2 Reasons for FI's position

Compared to the previous method, the buckets are slightly fewer in number and wider. New buckets have also been added to the top range, and figures are no longer rounded upwards.

The previous buckets for the leverage ratio guidance have worked as intended, but they did not fully cover the outcomes generated by the stress tests: relatively few institutions ended up in the lower buckets and relatively many institutions ended up in the “adjusted” category. FI therefore considers it to be appropriate to adjust the buckets so that they better reflect the actual distribution from the stress tests.

The aim of the changes is primarily to adjust the buckets so that they better reflect the distribution generated by the results of the stress tests. In addition, the same effects are achieved as with the proposed buckets for the risk-based guidance; in other words, managing the cyclical effect in the stress test method and achieving more stable and comparable guidances over time for banks in different supervision categories.

The Swedish Bankers' Association and the Association of Swedish Finance Houses highlight that the rounding does not fully reflect the proposal and also suggest that an extra bucket be added. FI considers the levels of the proposed buckets to be well-balanced but has updated the table and adjusted the upper and lower bucket threshold for the two lowest intervals, from 0.15 to 0.30, so there is no systematic rounding upwards for any of the buckets. The lowest bucket will also be somewhat wider than before.

The new bucket thresholds round to the bucket's mid-point for the two lowest buckets while the other buckets round downward. The reason for rounding to the middle and downward, respectively, is because the new buckets are wider; rounding upward would have a greater impact in the form of higher guidances compared to the narrower buckets that were previously used.

2.5 Limit on the size of the Pillar 2 guidance

FI's position: All institutions that, after any adjustments to the stress test, receive a stress test outcome that exceeds 5 per cent (risk-weighted) or 3 per cent in the leverage ratio (in other words, very high outcomes) will be placed in the highest category. If there are no other reasons to raise the guidance more than what is required following the stress test, this means in

practice that an institution normally will not be assigned a risk-based guidance that exceeds 5 per cent or a leverage ratio guidance that exceeds 3 per cent.

2.5.1 Feedback received

The Swedish Bankers' Association and the Association of Swedish Finance Houses support the proposal.

The Swedish Fintech Association is positive about the proposal but takes the position that it is unclear what could lead to a level higher than 5 per cent. It also welcomes FI's clarification that it must be possible to use P2G capital in practice and that this requires the company to fall below P2G on several occasions for FI to make a decision regarding an own funds requirement. However, it would like FI to clarify what "on several occasions" means in practice.

Klarna views positively that FI has chosen to limit the highest level to 5 per cent and to remove the level called "adjusted". However, it is not clear how strong the limitation to 5 per cent is in reality since FI still allows the possibility of assigning companies higher levels. Klarna would also like FI to clarify what the cap of 5 per cent entails and what the criteria would be to receive a guidance that exceeds this level.

The Riksbank is critical about the implementation of an upper limit for how much the outcome of the sensitivity-based stress test can contribute to the Pillar 2 guidance. It makes the assessment that these pre-determined levels create threshold effects and in practice will make it more difficult for FI to assign higher guidance levels in the future in the event this were justified.

2.5.2 Reasons for FI's position

An overall aim of FI's approach is to achieve predictability and equal treatment in the authority's assessment of the own funds levels that are suitable for each institution.

When introducing the previous approach to assess the size of the Pillar 2 guidance, FI made the assessment that most institutions would be assigned a risk-based guidance of 1.0–1.5 per cent of the risk-weighted assets and a leverage ratio guidance of 0.2–0.5 per cent of the leverage ratio exposure measure. At the same time, FI noted that the situation can differ between

institutions and the guidance can therefore be both higher and lower than these levels.

After having applied the approach for two years, we can see that most institutions subject to an SREP have received a risk-based guidance that is up to 2 per cent of the risk-weighted assets. A small number of institutions, on the other hand, has received significantly higher guidances, in some cases higher than 5 per cent of the risk-weighted assets, often as a direct result of how they perform in the stress test. Most institutions have received a leverage ratio guidance of up to 1.5 per cent, but a number of institutions has received a higher guidance as a result of the stress test.

These institutions often have weak profitability and had large losses in recent years. This in turn has been due to high credit losses or costs. Institutions that report recurring and often large losses have a larger need for buffer capital to be able to continue to conduct business while under financial stress. Subsequently, the relatively high guidances have been justified at the time they were assigned. However, FI takes the position that greater predictability and more equal treatment are strong reasons for limiting how large a guidance should normally be.

High volatility in different items in an institution's income statement means that the stress test outcomes can vary over time. Institutions that have been assigned relatively high guidances are often small and may not be assigned a new guidance for several years. Because a stress test is always based on historical figures, the point in time when FI performs an SREP on an institution can impact the outcome of the stress test and thus also the size of the guidance. FI tries to counteract undesirable variations in the outcomes by smoothing out items in the income statement and calculating an average over the past three years. Depending on where in the SREP cycle an institution is, however, one or several "bad" years can be included in the historical average for one institution but not for another.

Even if such differences in the size of the guidance can be justified at the time when the guidance is announced, it is not possible to disregard that over time there may be differences that appear to be unjustified for institutions that have fundamentally similar risks and business models. This is particularly the case for institutions where several years can pass between SREPs.

The risk of such differences arising can be limited by all institutions with very high capital volatility being placed in the same bucket and as a starting point being assigned the same size of guidance.

In practice, this means that the proposal entails a limit on how much an institution's historical losses can contribute to the size of a guidance. For institutions whose guidance is based on very high stress test outcomes, this creates better predictability about the size of future guidances and greater possibilities for steering their own capital planning.

One potential weakness in such a limitation is that an institution, at the time it is informed about the guidance, may have a greater need for buffer capital and that a suitable own funds level thus may be higher than what the guidance expresses. In this context, it should be emphasised that there are only a few institutions for which this situation will arise. If it does, it will be the responsibility of each individual institution to determine as part of their internal capital adequacy assessment process (ICAAP) if there is a need for more buffer capital and, in such a case, how much. The increased flexibility that a limitation on the size of the guidance can entail for some institutions thus needs to be offset by these institutions taking a greater responsibility for their capital planning. Since FI will announce the stress test's outcome and other potential considerations that serve as a basis for the guidance, the institution will have some basis for this assessment.

In this context, it is worth mentioning again the guidance's function and character. There is a strong expectation from FI that the institutions meet the guidance. However, it is possible to use the buffer in times of financial stress. The guidance is placed above the minimum requirements and the combined buffer requirement, and, unlike the combined buffer requirement, a breach of the guidance is not associated with any automatic restrictions on, for example, dividends or coupon payments on Tier 1 capital instruments.

In practice, this means that FI has considerable capacity for taking action, based on the specific situation, if the guidance is not met. The manoeuvrability is not limited to the size of the guidance.

Finansinspektionen always has the option of initiating more intense supervision of an institution if the circumstances give cause for such action regardless of the size of a previously assigned guidance. This includes the possibility of requesting a capital plan from the institution if this is judged to be necessary.

It is only if a bank breaches the guidance repeatedly that FI can decide on an additional own funds requirement for this specific reason. The restriction on the authority's authorisation that can be said to arise given the proposed limitation on the size of the guidance, in other words, is that the time for when such a decision can be made is pushed to a later date for a few institutions. However, it is FI's assessment that this does not impact its possibilities for conducting effective and suitable supervision.

Following an overall assessment, FI therefore takes the position that the need for equal treatment and predictability support that the approach should contain a limitation on how large a guidance should normally be.

FI takes the position that the proposed limitation on the size of the guidance should only apply when applicable own funds levels are established based on the stress test. There may still continue to be cause for FI, following a qualitative assessment, to assign an institution a guidance that exceeds 5 per cent and 3 per cent, respectively. See below under 2.6.

The Swedish Fintech Association and *Klarna* would like additional clarification about what could lead to a level of guidance that exceeds the cap. FI has chosen to limit the part of the outcome that is based on the results of the stress test. However, it is difficult to define in advance all of the situations that could lead to guidances that exceed 5 per cent and 3 per cent, respectively. If FI considers there to be a need for a guidance that exceeds these levels, the reasons for this will be clearly stated. Completely ruling out the possibility for FI to establish a guidance that exceeds 5 per cent and 3 per cent, respectively, would not be in line with the objectives that the Pillar 2 guidance is intended to meet. The alternative to making it possible for FI to exceed the stated limits of 5 per cent and 3 per cent, respectively, would be to not specify any limits at all in this general approach. However, FI considers that specifying a limit for what the institutions can normally expect still promotes predictability and equal treatment.

2.6 Consideration of other grounds for assessment

<p>FI's position: The need for a Pillar 2 guidance should initially be based on the outcome of the sensitivity-based stress test method. This outcome can be supplemented with additional grounds for assessment in order to both factor</p>

in other aspects that are not necessarily reflected by the stress test and be able to adjust any outcomes that for some reason may appear to be unreasonable.

To the extent that it is considered necessary, FI therefore intends to supplement the results from the stress test with other qualitative grounds for assessment and aspects. Where relevant, we will also consider the stress test led by the EBA.

2.6.1 Additional grounds for assessment

The need for a Pillar 2 guidance should initially be based on the outcome of the sensitivity-based stress test method. As described in section 2.3, the stress test is standardised in its first step and FI then makes institution-specific adjustments to the stress test, if necessary.

FI considers it to be neither suitable nor possible to mechanically rely on the result of a specific stress test. The results from the stress test after any quantitative adjustments may therefore need to be supplemented with additional grounds for assessment in order to weigh in other aspects that are not necessarily reflected in the stress test, for example aspects that cannot be quantified. However, the starting point is that the guidance will only be given in the form of the percentages set out in the tables in this memorandum. This means that if FI sees a reason for a guidance higher than 0.5 for a specific institution, the next guidance will be 1.0 and not a value in between.

It is not possible for FI to specify all of the additional grounds for assessment that may be included in this step. However, such grounds could include aspects not included in the sensitivity-based stress test method but that influence the bank's capital volatility, for example if there were major changes to a bank's business model or balance sheet that have not been captured by reported data or if the risks that the bank is primarily exposed to are not captured by the stress test. Similarly, considerable use of risk mitigation techniques, such as securitisations and credit guarantees, may need to be factored into the assessment. A lot of acquired receivables and surplus liquidity can also give cause for an additional assessment. Looking more closely at outcomes for a bank that has exceptionally good or bad profitability may also be relevant. If the bank's internal models have deficiencies that resulted in additional capital requirements, this may also need to be considered within a qualitative assessment. In this step, FI can

also take into consideration the stress test that the bank makes in its own internal capital assessment as well as its capital planning capacity. Other aspects may also be relevant to consider as well.

FI also intends to consider the outcomes for relevant comparative objects. This means that we will consider the final outcome from the stress test and any decided Pillar 2 guidances for institutions that, for example, have similar business models, are of a similar size or have a similar risk profile. This will ensure that an appropriate assessment is made in relation to comparable banks. This is particularly important for institutions where FI conducts an SREP more infrequently since the small adjustments are made to the stress test approach itself on an ongoing basis.

The EBA's stress test method

The EBA leads and coordinates stress tests of the largest banks in the EU every second year.¹⁵ The stress test is a bottom-up test. This means that the banks themselves perform many of the calculations but using a consistent method and a macrofinancial scenario that is developed through an EU-wide process. The EU supervisory authorities are responsible for the quality assurance of the results.

The stress test aims to assess the impact of different types of stress on the banks' capital adequacy. The banks included in the test estimate the impact on credit risk, market risk, counterparty risk, operational risks, and their main income items based on the severe scenario set by the European Systemic Risk Board (ESRB).

FI considers the EBA's stress test when assessing suitable Pillar 2 guidances for the banks included in the EBA's stress test.

2.6.2 Feedback received

The Swedish Bankers' Association is of the opinion that additional transparency and clarity is needed from FI regarding the qualitative grounds for assessment that could serve as a basis for the level of each guidance. All grounds for assessment and assumptions that may be used should be included in the method document that is now being updated so they also are included in the material made public by FI.

¹⁵ See "EBA launches 2023 EU-wide stress test", January 2023, for more information about the most recent version of the stress test. <https://www.eba.europa.eu/eba-launches-2023-eu-wide-stress-test-0>

The Swedish Bankers' Association is also of the opinion that the EBA's stress test should not be considered when assessing the Pillar 2 guidance. The EBA's stress test is designed from an EU perspective and adapted to generate certain results; therefore, according to the Swedish Bankers' Association, it should not constitute grounds for assessment for the Pillar 2 guidance. The Swedish Bankers' Association is also of the opinion that FI's written comments that the authority intends to consider the outcomes for relevant comparison objects in its assessment are not in line with the requirement that the Pillar 2 guidance must be institution specific.

The Association of Swedish Finance Houses would like to see greater transparency surrounding the qualitative grounds for assessment that can serve as a basis for the guidance.

The Swedish Fintech Association views FI's clarifications positively but would like FI to provide more clarification about our position on the grounds for assessment that the EBA lists in its SREP guidelines, particularly how we consider any management measures. It is also positive to FI's statement that it considers relevant comparison objects in its assessment of the size of the guidance. However, it would be desirable for FI to clarify which comparison groups it uses.

Klarna would also like FI to clarify how FI considers the EBA's guidelines, particularly with regard to the design of the stress test and how we consider the qualitative grounds for assessment listed by the EBA, for example management measures.

2.6.3 Reasons for FI's position

As stated above, it is not possible for FI to specify all of the additional grounds for assessment that may be included in this step. With regard to *the Swedish Fintech Association's* and *Klarna's* wish for clarification on FI's position on individual grounds of assessment in the EBA's guidelines, FI has considered them when the approach was developed and will also consider them when the approach is applied. How individual parts of the guidelines are considered is dependent, however, on the circumstances surrounding each case.

In terms of *the Swedish Bankers' Association's* comments regarding the EBA's stress tests, the EBA's guidelines state the competent authority should determine the Pillar 2 guidance outcome based on relevant

supervisory stress tests, including the EU-wide stress tests performed by the EBA. However, FI is aware of the differences in design and objective. The EBA's stress tests are also conducted only every second year and only for a few Swedish banks. The main basis for setting the Pillar 2 guidances for Swedish banks is FI's own approach, which is described in this memorandum.

FI intends when necessary to consider the outcomes for relevant comparative objects. Exactly what these comparative objects or comparative groups are can vary, and it is not possible to define them in advance. However, it must be emphasised that one institution's Pillar 2 guidance does not constitute grounds for assessment for another institution's guidance level. The main purpose of considering relevant comparative objects is to ensure equal treatment.

3 Public disclosure

3.1 Size of Pillar 2 guidance and FI's approaches

Every quarter FI publishes the memorandum "Capital requirements for Swedish banks" for banks in Supervision Categories 1 and 2. This document shows the banks' capital requirements and own funds at the end of each quarter.¹⁶ FI intends to publish the announced guidances in addition to the capital requirements, primarily for the banks that already are subject to FI's quarterly disclosures.¹⁷

FI also intends to publish every year a calibration memorandum that presents the calibration of the standardised parts of the stress test. Also, the calibration of some of the quantitative adjustments made to the stress test in the second step will be included in cases where they can be quantified in advance. FI will review the calibration every year since there is otherwise a risk that the approach will result in volatile outcomes.

Each bank, in conjunction with its verification letter in which FI states the preliminary guidance level, will also be given information about which

¹⁶ See the memorandum "De svenska bankernas kapitalkrav, fjärde kvartalet 2022" (FI Ref. 22-5832), 24 February 2023, FI, for more information and the most recent published version. Available in Swedish.

¹⁷ See section 3.9 of the capital requirement memorandum.

quantitative adjustments were made for the institution and the outcomes generated.

3.1.1 Feedback received

The Swedish Bankers' Association is of the opinion that FI must disclose more details surrounding the stress test, for example the calculation methods that are used.

The Swedish Fintech Association takes the position that FI's practice of publishing the outcome of the guidance for a sample of banks can jeopardise the usability of the guidance. Because the publication is not established practice in the rest of Europe, there is a risk that this will weaken Swedish banks' competitiveness internationally. FI published the approach for the previous capital planning buffer and the annual calibrations of the stress parameters. The Swedish Fintech Association would like the same level of openness also for the approach for the Pillar 2 guidance, particularly for companies that have an SREP more infrequently and cannot rely on the calibrations they were issued the year before. *Klarna* submitted similar feedback.

3.1.2 Reasons for FI's position

Several consultation bodies requested that FI present the stress test and its calibration in more detail. In order to further strengthen the concerned banks' possibilities for understanding FI's approaches, we intend to publish a calibration memorandum once a year. This section has been updated to reflect this.

In terms of the publication of the announced guidances, FI understands the feedback from *Klarna* and *the Swedish Fintech Association*. FI aims to be transparent and has therefore chosen to publish the levels for the Pillar 2 guidance at the same time as the minimum requirements, the Pillar 2 requirements and the buffer requirements. FI intends to continue to publish the level of the guidances.

4 Implications of the proposal

4.1 Implications for the banks

FI's impact analysis shows that the proposed buckets for the risk-based guidance would entail an unchanged guidance for the majority of the banks compared to today's bucket. The proposed buckets for the leverage ratio guidance would entail on average slightly lower levels compared to today. However, the final effect of the changed buckets is also dependent on the exact calibration of the stress test, which can vary from year to year.

FI's overall assessment is that the proposed changes and the exact calibration of the stress test will lead to a majority of the banks receiving changed or approximately the same guidances as under the current approach. The outcomes may differ, however, for each bank and may be slightly higher or slightly lower than today's approach for an individual bank.

In terms of the proposed maximum levels of 5 per cent and 3 per cent, respectively, only five banks have so far been assigned guidances that exceed these levels. The majority of these institutions have had significant losses in relation to their own funds. Typically, this is also the type of institution that can receive guidelines that are higher than 5 per cent and 3 per cent, respectively, in the future as well. FI will update its assessment of the banks that are assigned Pillar 2 guidelines that exceed 5 per cent and 3 per cent, respectively.

4.2 Implications for FI

FI makes the assessment that the proposed changes to the approach will not lead to any additional work for the authority.

Appendix 1 – Overall design of the sensitivity-based stress test

In this appendix, FI provides a general description of the stress test's main design. FI is developing and refining the test on an ongoing basis; therefore, some aspects may become irrelevant at the same time as new parts can be added. The description refers to the standardised stress test that is described in section 2.3.2.1, i.e., before any quantitative adjustments are made.

General methodology choices

The stress test refers to a three-year period and is constructed by changing the risk parameters, with the greatest stress applied to the firms in Year 1. The stress test is not based on any underlying macroeconomic scenario, but the calibration of the risk parameters is intended to correspond to a severe but not improbable financial shock.

The stress test uses reported financial data from the banks' balance sheet, income statement and capital situation. The benchmark (the base year) is the fourth quarter of the previous year for reported figures from the balance sheet and capital situation. For the income statement, the benchmark is the average of the past three years. The reason for this is that items in the income statement are more likely to vary from one year to the next.

The starting point for calculating the outcomes is a top-down approach, or in other words the calculations will be done by FI, with the exception of the stress applied to pension items in the balance sheet, where the banks themselves make certain calculations in accordance with FI's instructions. Data that serves as a basis for the calculations largely consists of the data the banks submit in their periodic reporting. To some extent data can also be gathered in other contexts, for example during the ongoing risk reviews that FI conducts with the banks.¹⁸

The outcome for the risk-weighted guidance is the largest reduction in CET 1 capital ratios under stress during the three-year period that the stress test covers. The outcome for the leverage ratio guidance is the largest reduction of the leverage ratio during the same period.

¹⁸ An additional information gathering request may be required to assess aspects that are not evident in the available information.

Stress applied to specific risk parameters

Representative income statement before stress

Since the profit for some firms varies significantly over time, FI considers it appropriate to base the underlying earnings on an average of the profit from the most recent three years adjusted for the change in the balance sheet during the three-year period. This is done by calculating the ratios for all material items in the income statement in relation to the balance sheet total. The average income or expense is then calculated separately for each item in relation to the balance sheet total during the three most recent years (i.e., the average ratio). Finally, the value for each item under stress is the average ratio multiplied by the average balance sheet during the previous year.

Stress applied to income and expenses

Income is primarily stressed through a standardised reduction of net interest income, net commission income and the financial net income. Other income such as dividends received and income from investments and joint ventures are similarly stressed. For some firms, there is a need to use a more risk-sensitive analysis that is based on more detailed data.

Since some banks in Categories 3 and 4 have significant leasing operations, this may be stressed explicitly.

The bank's administrative expenses are assumed to be unchanged under stress.

Credit losses

Credit losses are stressed through assumptions on specific loss ratios for different types of exposures that the bank has on its balance sheet (credit loss keys). These are placed in relation to the bank's historical credit loss levels multiplied by a certain factor. The approach that gives the highest outcome is used in the stress test.

Stress applied to operational losses

The stress test assumes that there is an operational loss event in Year 1. The loss is calibrated in relation to the size of historic net income.

Handling of assets and liabilities in the balance sheet

In general, it is assumed that the balance sheet is static in the stress test. This means that the composition of assets and liabilities is not changed by stress.

Stress applied to risk-weighted assets

In addition to the impact on the composition of the balance sheet, the risk-weighted exposures for credit risk can be influenced by changes in various risk parameters. The risk weights increase due to credit risk migration for the portfolios where the credit risk is covered using internal ratings-based models. We assume in the stress test that there is an increase in the risk-weighted assets that are calculated using internal models (REA-IRB). Also, the risk-weighted assets calculated using the standardised approach (REA-SA) increase by a certain percentage, although this increase is assumed to be smaller than for REA-IRB since the underlying risk weights in standardised approach are higher.

The balance sheet can also be impacted by depreciation or appreciation in the reporting currency.

Stress applied to pensions

When the value of a bank's pension assets or pension obligations changes, the size of the bank's own funds changes. Pension assets are valued at fair value while the value of a group's pension obligations is dependent on which assumptions that bank makes regarding, for example, the discount rate or inflation. FI will stress the assets' value, and the bank itself calculates the value of the stressed pension obligations given the parameter values that FI decides. See Appendix 2 for further details.

Other assumptions

If the firms make a profit in the stressed scenario, a deduction is made for tax according to the current corporate tax and the dividends in accordance with a standardised level.

Appendix 2 – Stress on pension items in the bank’s balance sheet

Pensions that are reported in the balance sheet can have a significant impact on a bank's own funds under unfavourable financial conditions and is therefore one of the items that Finansinspektionen stresses in the sensitivity-based stress test that serves as the basis for the Pillar 2 guidance.

How pensions impact own funds

There are many types of pension arrangements. It is only the arrangements that according to current reporting regulations must be included in the balance sheet that can impact the own funds. Pension arrangements that are never included in the balance sheet also cannot impact the own funds.

Pension items in the balance sheet can be pension assets or pension liabilities. How a certain pension arrangement, for example a pension plan, is reported in the balance sheet depends on, among other things, whether the arrangement entails a net asset or a net liability.

The value of the pensions’ plan assets is determined by prices and interest rate levels. Normally, these are listed on the financial markets. The value of pension obligations are determined by actuarial assumptions about the future, such as demographic assumptions about, for example, beneficiaries’ lifespan and early retirement or financial assumptions about the discount rate, inflation and tax. The total pension obligations in one arrangement constitute a pension liability.

According to the capital adequacy rules, the size of the own funds changes when the following items change in value: own funds items, adjustments, deductions or exemptions. When the value of pension items in the balance sheet changes, the size of the own funds item *accumulated other comprehensive income* also changes. At the same time, the size of the deduction changes when the pension items have changed value. However, the deduction can never be less than zero or larger than the pension assets in the balance sheet.

Why FI evaluates pension effect in P2G

The aggregate pension items are often large in relation to own funds. Small changes in assumptions about the future can therefore lead to large absolute

changes to pension items. This in turn can result in large changes in the own funds.

The value of pension items also changes frequently. Many plan assets are valued using market prices. This can lead to volatility in the capital ratios without anything needing to have changed in the bank's normal operations.

As a result of these phenomena, FI includes the effects of pensions in the sensitivity-based stress test that serves as a basis for the Pillar 2 guidance.

How FI evaluates pension effects in P2G

FI evaluates the pensions' impact on the own funds by adjusting the values of the parameters that determine the size of the pension items in the balance sheet. The adjustment should correspond to a financial shock that stresses the pension items and thus decreases own funds. In order to be able to correctly capture how changes in parameters can impact the balance sheet's pension items, we separate the pension items into smaller parts, for example individual pension plans, before starting the quantitative analysis.

The pensions' plan assets are stressed differently depending on whether interest rate levels have a direct impact on them or not. Assets that are only impacted indirectly or not at all by interest rate levels are stressed through relative value depreciation, which is the same for each type of asset but can be different for different types of assets, for example shares and real estate. Interest-bearing and other assets that are directly impacted by the interest rate level are stressed through a so-called parallel shift in the interest rate levels for all maturities. From that, the assets' value is assumed to change in proportion to the assets' modified duration.

If the entity that is tested is a Swedish group, the pension liability's size in the balance sheet is determined in accordance with the accounting standard IAS 19. FI does not have the possibility of calculating itself the outcome of changing the actuarial assumption that serve as a basis for the calculation of the pension obligations. Therefore, FI will choose a stressed level of the parameters, for example discount rates and expected inflation, and allow the banks to calculate the value of their pension obligations themselves. This is because firms that use IAS 19 have relatively large freedom in determining the value of the parameters that determine the pension liability. A common level therefore allows for a higher degree of equal treatment under stress.

Regardless of the levels of the parameters a bank has at the outset, FI evaluates the total impact on the own funds that comes from our stressed assumptions. If the total effect leads to a reduction of the own funds, the reduction will be included in the outcome of the sensitivity-based stress test. There is also a small possibility that the levels a bank uses for its parameters are conservative enough for the total outcome of the pension stress to generate a surplus in own funds. The surplus is then used to cover deficits that have been generated in other parts of the sensitivity-based stress test.

If instead it is a Swedish legal person that is being assessed, the pension liability will not change in size if the firm applies supplementary accounting rules for legal entities (RFR 2) from the Swedish Financial Reporting Board. The pension obligations are then discounted by an interest rate that is set once a year and is not directly linked to market listed interest rate levels. The size of the pension liability therefore does not change under stress in this case.