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C O N S U L T A T I O N   M E M O R A N D U M

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Changed method for the application of the risk weight floor for Swedish mortgages

Summary

Finansinspektionen (FI) is proposing to change the method it currently uses to apply the current risk weight floor for Swedish mortgages through Pillar 2 by replacing it with a requirement within the framework of Article 458 of Regulation (EU) No 575/2013 of the European Parliament and of the Council of 26 June 2013 on prudential requirements for credit institutions and investment firms and amending Regulation (EU) No 648/2012 (CRR). The new requirement will be included in the Pillar 1 requirements.

The main reason for the proposed change is structural changes on the Swedish banking market. Nordea Bank AB decided on 15 March 2018 to move its head office from Sweden to Finland. FI makes the assessment that this change in market structure could lead to a situation where different participants on the Swedish mortgage market will face different capital requirements for Swedish mortgage exposures. FI has therefore evaluated how it can counteract a distortion in the competition on the market and makes the assessment that the manner in which the risk weight floor is currently applied needs to change. This change is also necessary to ensure the current level of capital requirements for mortgage exposures in Sweden. Both of these goals can be achieved by replacing the current risk weight floor with a requirement under Article 458 of the CRR.

The credit institutions that are proposed to be subject to the measure are the credit institutions that have permission to use the IRB approach and have an exposure to Swedish mortgages. Branches of foreign credit institutions in Sweden that are exposed to Swedish mortgages and use the IRB approach for these exposures may also be affected.

The total capital need of the credit institutions is not significantly changed as a result of the proposed measure. The capital requirements that previously were set through the risk-weight floor for Swedish mortgages in Pillar 2 will now be set through Pillar 1. The proposed measure has a negligible effect on the capital requirements in SEK due to the design of the measure, which aims to keep the same capital requirements in nominal terms as the current requirements. The measure therefore ensures that Swedish credit institutions even in the future

will have equally high capital buffers for systemic risks linked to Swedish mortgages as under the current capital requirements. Swedish credit institutions will thus continue to be resilient. The measure, however, will reduce the capital requirements and capital levels expressed in per cent of risk-weighted assets. This reduction is only a technical effect of replacing the Pillar 2 risk weight floor for mortgages with a Pillar 1 requirement. The change will result in an increase in the risk-weighted exposure amounts, which in turn will reduce the capital ratios. The effect on the Swedish credit institutions' capital levels and capital requirements in SEK is negligible, however.

One consequence of introducing the risk weight floor through Article 458 of the CRR is that the share of the capital requirements in Pillar 1 will increase. This reduces the margin to the level when the automatic dividend restrictions enter into force. This could mean that the level at which FI must intervene may occur earlier than given today's risk weight floor in Pillar 2. FI makes the assessment that Swedish credit institutions will continue to have satisfactory margins even after the measure has been implemented. FI is also able to reassess and withdraw a measure under Article 458 of the CRR, which would then apply to all credit institutions covered by the measure. This is in line with the purpose of Article 458, which allows a measure imposed under the article to be revoked if the macroprudential or systemic risk ceases to exist. This enables FI to achieve a similar buffer function at the systemic level as with today's risk weight floor in Pillar 2.

The application of the risk weight floor for Swedish mortgages as a requirement under Article 458 of the CRR is proposed to enter into force on 31 December 2018.

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1 Introduction and background

1.1 Purpose

Finansinspektionen (FI) is proposing to change the method it currently uses to apply the current risk weight floor for Swedish mortgages through Pillar 2 by replacing it with a requirement within the framework of Article 458 of Regulation (EU) No 575/2013 of the European Parliament and of the Council of 26 June 2013 on prudential requirements for credit institutions and investment firms and amending Regulation (EU) No 648/2012. The new requirement will be included in the Pillar 1 requirements.

The proposed change in the design of the risk weight floor for Swedish mortgages is necessary primarily due to structural changes on the Swedish banking market. Nordea Bank AB (Nordea) decided on 15 March 2018 to move its head office from Sweden to Finland. FI makes the assessment that this change in market structure could lead to a situation where different participants on the Swedish mortgage market will face different capital requirements for Swedish mortgage exposures. FI has therefore evaluated how it can counteract a distortion in the competition on the market and makes the assessment that the manner in which the risk weight floor is currently applied needs to change. This change is also necessary to maintain a level playing field and ensure the current level of capital requirements for mortgage exposures in Sweden. Both goals can be achieved by replacing the current risk weight floor with a requirement under Article 458 of the CRR.

The aim of this memorandum is to describe the new method for the application of the risk weight floor and the impact of the change. In this memorandum, the term "credit institution" is used for all banks and credit market companies that are subject to the capital adequacy regulations.

1.2 Current and future rules

1.2.1 The current risk weight floor for Swedish mortgages

The risk weight floor in Pillar 2 for Swedish mortgage exposures constitutes an important part of FI's current capital requirements. The floor applies to credit institutions that have permission to use the internal ratings-based approach (IRB approach). The floor was introduced as part of the supervisory capital assessment in Pillar 2. The Pillar 2 requirement is set for individual institutions to cover risks that are not fully captured by the regulations' minimum and buffer requirements and is evaluated on an ongoing basis as part of the supervisory review and evaluation process (SREP).

The risk weight floor was introduced on 21 May 2013.[1] The average risk weight at the portfolio level was set at 15 per cent with the argument that there is a risk that the credit institutions' IRB approaches do not fully capture the credit loss risk of Swedish mortgages.[2] In Sweden, internal credit risk models, which are based on historical outcome, often generate risk weights that are too low since credit losses in the mortgage portfolios have been very low for a long period of time. However, FI realised already when the floor was introduced that it was crucial for the stability of individual credit institutions as well as the Swedish financial sector for the credit institutions to hold own funds that cover the risks in the Swedish mortgage portfolios from a wider and more forward-looking perspective.

FI's assessment was therefore that the risk weight floor needed to be raised even higher to take into account the broader systemic risks that could arise from the Swedish mortgages of individual credit institutions. On 8 September 2014, FI therefore raised the level of the risk weight floor to 25 per cent to also cover systemic risks related to mortgages.[3] The measure was justified by the Swedish mortgage market's size and importance for both individual credit institutions and financial stability in Sweden.

1.2.1.1 Capital requirements and capital type in the current risk weight floor

To estimate the impact of the current risk weight floor, the exposure amount for Swedish mortgages is first multiplied by the difference between 25 per cent (the risk weight floor) and the institution's actual risk weight in Pillar 1 for the corresponding portfolio. This amount is then multiplied by the applicable capital requirement, which includes all Pillar 1 capital requirements, including the capital conservation buffer and the countercyclical buffer rate for Sweden. For the four banks in Supervision Category 1, i.e. Handelsbanken, Nordea, SEB and Swedbank, the total capital requirement for systemic risk is also considered.[4]

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[1] *Risk Weight Floor for Swedish Mortgages*, May 2013, FI. https://www.fi.se/en/published/news/2013/decision-to-implement-a-risk-weight-floor-for-mortgages/. When the risk weight floor was introduced, the "old" capital adequacy regulations were still in effect in Sweden, i.e. the Capital Adequacy and Large Exposures Act (2006:1371). The risk weight floor was therefore designed with its legal basis in the then-applicable regulations, which did not contain an explicit legal basis for an additional capital requirement for systemic risk.

[2] The conclusion that risk weights for Swedish mortgages should be at least 15 per cent was the result of an overall assessment of future loss levels in Swedish mortgages in a situation of intense financial stress.

[3] *Capital Requirements for Swedish Banks*, September 2014, FI. https://www.fi.se/en/published/news/2014/capital-requirements-for-swedish-banks/.

[4] This means that in addition to the system risk buffer of 3 per cent, the capital requirement for system risk of 2 per cent imposed on the four largest banks within the framework of Pillar 2 will also be taken into account when calculating the capital requirement for Swedish mortgages.

This means that the current risk weight floor for the major banks is calculated using a total capital requirement of 15.5 per cent plus the countercyclical buffer rate. For other credit institutions, the risk weight floor is calculated using a capital requirement of 10.5 per cent plus the countercyclical buffer rate. The type of capital used today to meet the requirement on the risk weight floor for Swedish mortgages has the same distribution as the Pillar 1 capital requirement, including all buffer requirements.

1.2.2 Future regulations

The current design of the capital requirements for Swedish banks will change following the outcome of the ongoing review of the EU's regulations for capital adequacy and the new standards from the Basel Committee for Banking Supervision (the Basel Committee), which will then be introduced into the EU regulatory framework.

The Basel Committee presented in December 2017 supplements that are intended to complete the global standards for credit institutions' capital adequacy (Basel III).[5] Several standards were revised and Swedish credit institutions will need to use new methods to calculate their capital requirements.[6] In addition to changing the method for the standardised approach, there will also be a new floor for risk-weighted assets for credit institutions that apply internal models. The Basel floor is expected to result in higher average risk weights for Swedish credit institutions' mortgage exposures than the risk weights calculated using internal models.

In addition to the Basel Committee's accord, there is also a review currently under way of the EU's capital adequacy regulations (the Capital Requirements Regulation and the Capital Requirements Directive[7]). The European Commission's proposal, which is under negotiation within the EU, could lead to a change in how national supervisory authorities may use Pillar 2. For example, the Commission proposes a limitation on Pillar 2 add-ons for systemic risks. If the Commission's proposal materialises, the application of today's systemic-risk-based risk weight floor for mortgages in Pillar 2 will be affected.

It is important to assess the total effect of regulation changes resulting from the new Basel standards and the ongoing EU negotiations. FI will adapt the design

[5] See Basel III: Finalising post-crisis reforms, December 2017, Bank for International Settlements.

[6] The Basel standards need to be negotiated and implemented in the EU before they enter into force. The final design is thus not completed yet.

[7] Directive 2013/36/EU of the European Parliament and of the Council of 26 June 2013 on access to the activity of credit institutions and the prudential supervision of credit institutions and investment firms, amending Directive 2002/87/EC and repealing Directives 2006/48/EC and 2006/49/EC.

and application of the capital requirements, including capital requirements for mortgages, once the new regulations are adapted and fully implemented.

1.3 Structural changes on the Swedish banking market

The proposed change in the design of the risk weight floor for Swedish mortgages is necessary primarily given the structural changes on the Swedish banking market. Nordea decided on 15 March 2018 to move its head office from Sweden to Finland. Such a move requires permission from FI, Finland's supervisory authority, Finansinspektionen (FIVA), and the European Central Bank (ECB). The scope of Nordea's operations in Sweden will not change following the planned move. However, the move will have a major impact on the distribution of responsibility for supervision and crisis management between the authorities in the affected countries. Supervision responsibility for Nordea with regard to capital, liquidity and risk management will lie with the Banking Union's central supervisory body, Single Supervisory Mechanism (SSM)/ECB, while FIVA will be the responsible authority for macroprudential policy.

It is assumed that, after the move, Nordea's operations in Sweden will consist of a significant branch[8] and a number of subsidiaries, including Nordea Hypotek AB, which is classified as a credit institution. FI will become a host country authority for the Swedish branch and the competent supervisory authority for the Swedish subsidiaries. Since Nordea will be a significant branch, FI will participate in its supervisory college. FI makes the assessment, however, that the supervision practice applied by the SSM/ECB makes it difficult to apply the Swedish risk weight floor as it is designed today. One effect of this could be that Nordea, by moving its head office to another country, may at least initially be subject to lower capital requirements at the group level for its Swedish mortgage exposures than it is today.

Therefore, due to Nordea's planned move, FI has evaluated how it can counteract a distortion in the competition on the market and makes the assessment that the manner in which the risk weight floor is currently applied needs to change. This change is necessary to maintain a level playing field and ensure the current level of capital requirements for mortgage exposures in Sweden.

[8] "Significant branch" is defined in Chapter 1, section 5, point 22 of the Banking and Financing Business Act (2004:297). According to the forthcoming guidelines from the EBA regarding supervision of significant branches (EBA/GL/2017/14), which are expected to be adopted in Sweden, and given the size of Nordea Bank AB and the significant role it currently holds on the Swedish market, Nordea's Swedish branch is most likely expected to also classify as a "significant-plus branch".

1.4 Article 458 of the CRR helps safeguard capital requirements and a level playing field

Credit institutions domiciled in other countries may be exposed to and give rise to risks in the Swedish mortgage market through branches or subsidiaries in Sweden. The Nordic market is highly interconnected directly through counterparty exposures and indirectly through similar business models and risk exposures. The financial stability in one country is thus greatly affected by the financial stability in the other countries and in the Nordic-Baltic region as a whole.

There is a principle of home country supervision according to the rules that apply to credit institutions. This means that the competent authority in a credit institution's home country is primarily responsible for the supervision of the institution's foreign branches.[9] Host countries with significant branches according to Article 51(1) of the CRD become members of a supervisory college and thus participate in information sharing and risk assessment.

In order for macroprudential measures to achieve the intended effect, they need to cover all credit institutions active on the market in question, regardless of the legal domicile. Foreign branches should therefore also be covered by a measure that is taken in the host country to manage national systemic risks. The principle of reciprocity[10] for national macroprudential measures is important in this context. It ensures that the same macroprudential regulations apply to the same type of risk exposure in a country, regardless of the credit institution's legal status and domicile.

The capital adequacy regulations offer the possibility, on a voluntary basis, to request and achieve reciprocity of capital requirements in Pillar 2 within the framework of supervisory colleges. FI has used this opportunity to ensure that the current risk weight floor also includes the Swedish branches of foreign credit institution. Danske Bank's branch in Sweden is currently the only foreign branch that uses the IRB approach and conducts substantial operations on the Swedish mortgage market. FI requested in connection with the implementation of the current risk weight floor that the Danish supervisory authority take into consideration the systemic risks on the Swedish mortgage market in its supervisory capital assessment of Danske Bank. This resulted in reciprocal recognition of the risk weight floor in the bank's Pillar 2 requirements.

[9] Chapter 13 of the Banking and Financing Business Act (2004:297).

[10] Reciprocity means that a competent authority in a jurisdiction applies the same, or an equivalent, macroprudential measure as decided by a relevant authority in another jurisdiction to all financial institutions in its jurisdiction when they are exposed to the same risk in the latter authority's jurisdiction.

However, the capital adequacy regulations do not clearly define reciprocity for Pillar 2 requirements. Neither is there a clearly defined mandate for the European Systemic Risk Board (ESRB) to issue recommendations to Member States regarding reciprocity of capital requirements in Pillar 2. FI notes in this context, however, that the possibility to request reciprocity is clearly stated for measures implemented within the framework of Article 458 of the CRR.
A host country, in accordance with Article 458(5) of the CRR, is then able to apply for reciprocity of the measures and for other Member States to also apply them to nationally authorised branches located in the host country.

In this context, it is important to note that a risk weight floor in the form of a Pillar 1 requirement under Article 458 of the CRR will apply directly to foreign credit institutions' subsidiaries that are credit institutions in Sweden. The measure will thus affect their exposures also at the group level. It is therefore not necessary to ask for reciprocity of the measure for these credit institutions' exposures to the Swedish mortgage market. However, reciprocity of the risk weight floor from other Member States is necessary in order for the measure to apply also to Swedish mortgage exposures in foreign credit institutions' branches in Sweden and thereby also at group level.

FI therefore believes that an implementation of the risk weight floor under Article 458 will make it easier to ensure that foreign credit institutions' exposures to Swedish mortgages are covered by the risk weight floor. The measure gives FI the possibility of maintaining a level playing field on the Swedish mortgage market and ensuring the current level of capital requirements for mortgage exposures in Sweden.

1.5 Legal basis

According to Chapter 1, section 6, second paragraph of the Special Supervision of Credit Institutions and Investment Firms Act (2014:968) (the Supervision Act), FI is the competent authority that decides on special macroprudential measures in accordance with Article 458 of the CRR.

According to Article 458(2) of the CRR, the competent authority can decide on certain stricter national measures, if it "identifies changes in the intensity of macroprudential or systemic risk in the financial system with the potential to have serious negative consequences to the financial system and the real economy". One example of such a measure is higher risk weights to target asset bubbles in the residential property sector. Before the measures are adopted, the authority shall notify the European Parliament, the Council, the Commission, the ESRB and the European Banking Authority (EBA) about the measures and, in accordance with Article 458(2)(a-f) of the CRR, submit relevant quantitative or qualitative evidence for why the measures are necessary. The Council, on the proposal by the Commission, may reject the national measures by adopting an implementing act. If this does not occur within given deadlines, the Member State may adopt and apply the macroprudential measure.

As a result, FI, within the framework of Pillar 1 and given certain conditions, may temporarily increase risk weights for mortgages and commercial properties. FI intends pursuant to Article 458(2) of the CRR to introduce a risk weight floor of 25 per cent for Swedish mortgage exposures for credit institutions that have authorisation to use the IRB approach. This risk weight floor will apply directly in Pillar 1 and replace the corresponding risk weight floor that currently applies in Pillar 2. The risk weight floor implies that the risk weight that is calculated for the current exposures in accordance with Part Three, Title II of the CRR may not be less than 25 per cent.

The implementation of the proposed measure will be conditional on the Council, on a proposal by the Commission, not deciding to adopt an implementing act to reject the draft measure in accordance with Article 458(4) of the CRR.

On the condition that the proposed measure is not rejected, FI will then immediately and pursuant to Article 458(4) of the CRR, adopt the measure through individual decisions for the credit institutions that have mortgage exposures in Sweden and that apply the IRB approach. FI's mandate to announce decisions in accordance with the CRR is set out by the regulation itself. No national legislative measures are required for FI to be able to announce the individual decisions made possible through the CRR.[11]

The measure is proposed to enter into force on 31 December 2018 and apply for a period of two years or until the macroprudential risk ceases to exist, with the possibility of an extension of one additional year at a time according to Articles 458(4) and 458(9) of the CRR. In the event that FI, after the decision has been made, makes the assessment that the measure should be withdrawn because the macroprudential risk has ceased to exist, it is not necessary to follow the same notifying procedure as mentioned above.

FI will also apply for reciprocity of the measure to ensure that other Member States apply it to nationally authorised branches located in Sweden in accordance with Article 458(5) of the CRR. This would entail that the measure is applied to exposures to Swedish mortgages in foreign credit institutions' branches in Sweden. The application for reciprocity will be sent to the ESRB, which can issue a recommendation to the Member States to reciprocate the Swedish risk weight floor for mortgages in accordance with Article 458(8) of the CRR.

1.6 Preparation

In its work to prepare a proposal for a risk weight floor for Swedish mortgages within the framework of Article 458 of the CRR, FI has held a dialogue with an

[11] Bill 2013/14:228 p. 125.

external reference group. This group included the Swedish Bankers' Association and the Swedish Savings Banks Association as well as several of their affected members. FI also held bilateral meetings with most of the affected credit institutions, including both major banks and mid-size credit institutions, in order to obtain their view on the proposed measure at an early stage. Moreover, FI has conferred with the Swedish National Debt Office to assure the quality of the calculation of the impact of the measure on the credit institutions' requirements on bail-inable debt (so-called MREL requirements) as well as the impact analysis in general in order to take into consideration other effects that may result from the measure. Finally, FI informed the members of the Financial Stability Council about the work on the proposal.[12]

The consultation bodies are now given the opportunity to provide feedback on the implementation of the risk weight floor for mortgages under Article 458 of the CRR. Any viewpoints must be submitted no later than 30 April 2018.

[12] The Financial Stability Council is a forum for representatives from the Government, Finansinspektionen, the Swedish National Debt Office and the Riksbank. The Council discusses matter related to financial stability and how to counteract financial imbalances.

2 Reasoning and considerations

FI is proposing to change the method it uses to apply the current risk weight floor for Swedish mortgages through Pillar 2 by replacing it with a requirement under Article 458 of the Capital Requirements Regulation. The new requirement will be included in the Pillar 1 requirements.

2.1 Risks associated with Swedish mortgages

The assessment of the risks associated with mortgage lending that FI presented in connection with the introduction of the risk weight floor for mortgages in Pillar 2 has not changed.[13] Both house prices and household debt have increased rapidly over a long period of time and at a faster rate than household income. The high and rising debt of households represents a significant vulnerability in the Swedish financial system. This increases the risks in the macroeconomy and, by extension, the risks posed to financial stability in Sweden.[14]

Mortgages make up the majority of Swedish households' total debt. High indebtedness, combined with a large share of loans with short interest rate adjustment periods, makes households sensitive to changes in interest rates. The home is also many households' single largest asset. If house prices were to fall or interest rates were to rise, there is a risk that household behaviour could amplify a downturn in the economy through reduced consumption. This, in turn, could weaken credit quality in other sectors to which the credit institutions are exposed. Such a development could ultimately threaten financial stability in the long run.

Swedish mortgages also comprise a large share of credit institutions' total assets. They also constitute the majority of the cover pool that serves as a basis for one of the banks' most important funding sources - covered bonds. A shock to the supply of credit to households could create or enhance a negative trend on the housing market and household sector. This could cause serious problems for both the financial system and the Swedish economy at large. It is therefore important for firms on the mortgage market to have sufficient resilience for handling shocks without needing to dramatically change their lending procedures. By holding enough capital for their mortgage exposures, the credit institutions increase their capacity for managing any losses without reducing their lending. Sufficient capital also reduces the risk that investors will lose

[13] See also Chapter 4 "Increase to the risk weight floor for Swedish mortgages" in *Capital Requirements for Swedish Bank*s, September 2014. https://www.fi.se/en/published/news/2014/capital-requirements-for-swedish-banks/.

[14] The systemic risks posed by Swedish mortgages and the developments on the Swedish housing market have also been highlighted by international bodies such as the International Monetary Fund (IMF), ESRB and the European Commission. These bodies highlight the risks of high and rising household debt and house prices that are judged to be overvalued. There is also a risk for potential cross-border effects in other Nordic and Baltic countries if risks materialise.

confidence in the credit institutions' ability to manage shocks to household finances and the Swedish economy. In turn, this reduces the risk of shocks to the credit institutions' funding.

As a whole, rising house prices and household debt have elevated the systemic risks. These risks are not fully covered by the institution-specific capital requirements in accordance with Pillar 1. Thus, there remains a need for the risk weight floor to ensure that credit institutions that issue mortgages are sufficiently resilient for managing shocks without being forced to adapt in such a manner as to create or strengthen a negative development.

2.2 A risk-weight floor of 25 per cent for mortgages

2.2.1 Definition of affected portfolio

The portfolio covered by the proposed measure and that in this memorandum, similar to the current treatment of the risk weight floor in Pillar 2, has been given the simplified name "Swedish mortgages" consists of exposures in Sweden collateralised by property within the exposure class 'exposures to households'. In other words, exposures located in Sweden that are handled in accordance with Article 147(2)(d) of the CRR. The exposure class by far largely consists of mortgages for private individuals, but can also include certain exposures to small corporations with loans collateralised by real estate and exposures collateralised by real estate other than residential properties.

In accordance with the current calculation of the risk weight floor in Pillar 2, it is proposed that the calculation be based on reported data in the COREP-template based on the following cells:

- C 09.02 – Geographical breakdown of exposures by residence of the obligor: IRB exposures (CR GB 2), Sweden.
    - Row 070, columns 105 and 125.

For institutions that are subject to the measure but do not report in accordance with C 09.02, the following is proposed:

- C 08.01– Credit and counterparty credit risks and free deliveries: IRB approach to own funds requirements (CR IBR 1)
    - Row 010, column 260.

2.2.2 Definition of average risk weight

The proposed measure refers to the exposure-weighted average risk weight. This is calculated by dividing the portfolio's risk-weighted exposure amount by the exposure amount (EAD). This means that:

$$Additional\ risk - weighted\ assets\ according\ to\ Article\ 458 \\ = EAD\ \times (25\% - current\ risk\ weight)$$

For an institution that reports in template C09.02, the calculated requirement in accordance with Article 458 shall be as follows:

$$Additional\ risk - weighted\ assets\ according\ to\ Article\ 458 = C\ 09.02, row\ 070, column\ 105\ \times \left(25\% - \frac{C\ 09.02, row\ 070, column\ 125}{C\ 09.02, row\ 070, column\ 105}\right)$$

2.2.3 Reporting

The additional risk-weighted assets through Article 458 shall be reported in template C 02.00, rows 730 and 710. The measure therefore also affects row 010, "total risk-weighted exposure amount", in the template.

2.2.4 Calculation of capital requirements

To estimate the impact of the risk weight floor when it is applied through Article 458 of the CRR, the exposure amount for Swedish mortgages is first multiplied by the difference between 25 per cent (the risk weight floor) and the institution's risk weight in Pillar 1 for the corresponding portfolio. This amount is then multiplied by the applicable capital requirement.

It is FI's intention to achieve the same effect as today's handling through Pillar 2. This means that the risk weight floor for the major banks is calculated using a total capital requirement of 15.5 per cent plus the countercyclical buffer rate. For other credit institutions, the calculation uses a capital requirement of 10.5 per cent plus the countercyclical buffer rate.[15]

When the institution-specific countercyclical capital buffer is calculated, it is FI's assessment that the minimum capital requirements for the relevant exposures must include the additional capital requirement from the increase in the risk weight for exposures in Sweden collateralised by property in the exposure class, *exposures to households*. By using Article 458, the risk weights in Part Three, Title II of the CRR increase and thus the risk-weighted assets for the credit risk exposures.

FI's starting point is that it is the underlying credit risk exposures that form the basis for which relevant exposures and related capital requirement are to be included in the calculation. This assessment is not changed by the fact that risk weights increase with support of Article 458.

The effect of the countercyclical buffer on the capital requirement, both in nominal terms and in per cent, is affected by the level of the relevant exposures, their geographic distribution and the level of the countercyclical

[15] In other words, in the same manner as the current risk weight floor, see also section 1.2.1.1. The design of the measure also entails that the share of the requirement that will be met by CET 1 capital is the same as before.

capital buffer that applies to Sweden in relation to the institution-specific buffer rate. The proposed method therefore entails that the countercyclical capital buffer requirement could have varying consequences for the affected credit institutions.

A more detailed description of the effect of the capital requirement and its components is found in the box below.

- **The risk weight floor for Swedish mortgages in Pillar 2** of 25 per cent in total is removed and replaced with a risk weight floor for mortgages in Pillar 1.
- **The minimum requirement** increases as a direct effect of the increase in the risk-weighted assets
- **Capital requirements in Pillar 2** are changed due to requirements that are expressed in relation to the risk-weighted assets.
- **The capital conservation buffer** of 2.5 per cent increases in nominal terms due to higher risk-weighted assets.
- **Capital planning buffer.** FI's stress tests for 2017 that aim to set the capital planning buffer have shown that the capital planning buffer does not exceed 2.5 per cent. A buffer requirement other than the capital conservation buffer is therefore not included in the example.
- **The systemic risk buffer/buffer for systemically important institutions** of 3.0 per cent (for the major banks) as part of the combined buffer requirement increases in nominal terms due to higher risk-weighted assets.
- **The systemic risk buffer in Pillar 2** of 2.0 per cent (for the major banks) increases in nominal terms due to higher risk-weighted assets.
- **The countercyclical capital buffer** increases in nominal terms due to higher risk-weighted assets. The Swedish buffer rate is 2 per cent.

2.3 The risk weight floor's buffer functionality

The overall capital requirements are made up of different components, minimum requirements and buffers, which in turn can be applied in Pillar 1 or Pillar 2. Minimum requirements and buffers are meant to fulfil in part differing purposes. A credit institution that does not meet the minimum requirement has not fulfilled the conditions for the authorisation to conduct business. This means that FI must intervene, which could result in the credit institution being wound up or placed into resolution. A high minimum requirement could reduce the risk that lenders will suffer losses due to a default, but does not necessary reduce the probability that a default will occur. Capital buffers in part fulfil a different function than the minimum requirements in that credit institutions under certain circumstances and given certain restrictions can use the buffers without risking default. Large buffers thus make credit institutions more resilient to losses. This reduces in turn the probability that they will breach the minimum requirements and that the problems that can arise as a result of this will spread to other parts of the financial system. Large buffers therefore increase the stability of both the credit institutions and the financial system.

The Pillar 2 increment is the supervisory authority's requirements on individual institutions and is to cover risks that are not fully captured by the regulation's minimum and buffer requirements. This may mean a higher capital requirement for risks that are not at all covered by Pillar 1, a risk that is partly covered by Pillar 1 or an additional buffer for risks to which the credit institution exposes the financial system. Both the level of the Pillar 2 requirement and the consequence of not maintaining this level are determined by FI and depend on the circumstances at any given point in time. If a credit institution is under severe financial stress, its risk profile can change in a short period of time. For example, certain risks included in the assessment of the Pillar 2 requirement might have materialised, which might mean there are no longer grounds for requiring the credit institution to hold capital for them. Large parts of the Pillar 2 requirement, therefore, can be viewed in practice and under certain circumstances as an additional capital buffer. FI can also reassess the Pillar 2 requirements.

When a measure under Article 458 of the CRR is implemented, the share of Pillar 1 capital requirements increases. This reduces the margin to the level when the automatic dividend restrictions enter into force. This could mean that the level at which FI must intervene may occur earlier than given today's risk weight floor in Pillar 2. It is therefore in this context very important to emphasise that FI is able to reassess and withdraw a measure under Article 458, which is in line with the intent of this article. Article 458(4) of the CRR states that the measure can apply for a period up to two years or until the macroprudential risk or systemic risk ceases to exist, if this occurs earlier. This means that if the risk materialises, FI may reassess the measure, lower the level and, as a last step, deactivate the measure. This enables FI to achieve a similar buffer function at the systemic level as with today's risk weight floor in Pillar 2.

2.4 Application area of the measure

2.4.1 Scope

The credit institutions that are proposed to fall under the measure are the credit institutions that have authorisation to use the IRB approach and have an exposure to Swedish mortgages.[16] The requirement applies to the individual institutions as well as the consolidated situation.

[16] This includes the Sweden-based subsidiaries of foreign credit institutions.

If a new credit institution were to receive authorisation to use the IRB approach to calculate the capital requirement for Swedish mortgages, this credit institution would also be covered by the measure. Credit institutions using the standardised approach to calculate the capital requirement for credit risk are not affected.

Branches of foreign credit institutions in Sweden that are exposed to Swedish mortgages and use the IRB approach for these exposures may also be affected. The conditions for this are described in section 2.4.2.

2.4.2 Foreign branches may be covered through reciprocity

Section 1.5 describes the legal basis for FI to implement a national measure within the framework of Article 458 of the CRR. FI has decision-making powers for the capital requirement for credit institutions domiciled in Sweden, but not for foreign branches in Sweden. However, FI is able to influence the capital requirement for foreign branches' operations in Sweden by requesting reciprocity of the Swedish measure.

FI will apply for reciprocity of the proposed measure to ensure that the requirement also includes foreign branches. Reciprocity means that other EU Member States will apply the Swedish risk weight floor for mortgages set in accordance with Article 458 to nationally authorised branches located in Sweden in accordance with Article 458(5) of the CRR. This in turn means that the measure will be applied to Swedish mortgage exposures in foreign credit institutions' branches in Sweden.

2.5 Entry into force

The measure is proposed to enter into force as of 31 December 2018.

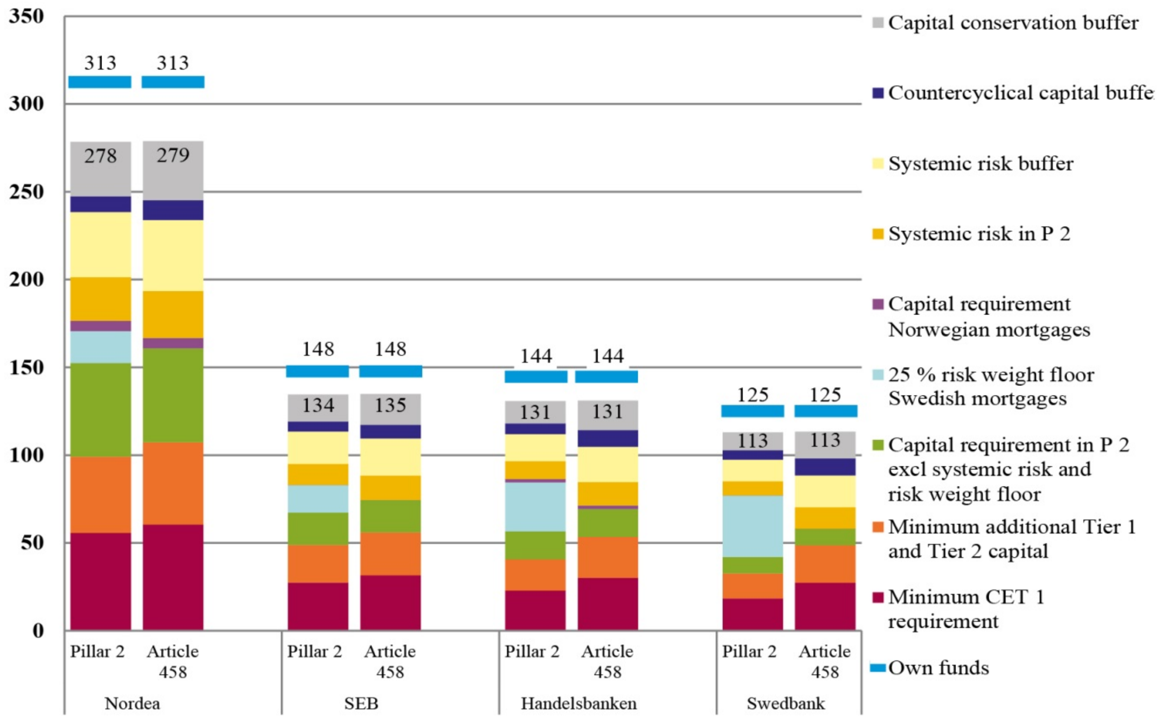
3 Impact of the measure

The following section describes the impact of FI's proposed application of a risk weight floor through Article 458 of the CRR on individual credit institutions, competition, the market, households and the economy. The impact was estimated based on the data reported to FI and refers to Q4 2017.

3.1 Effects of the capital requirement

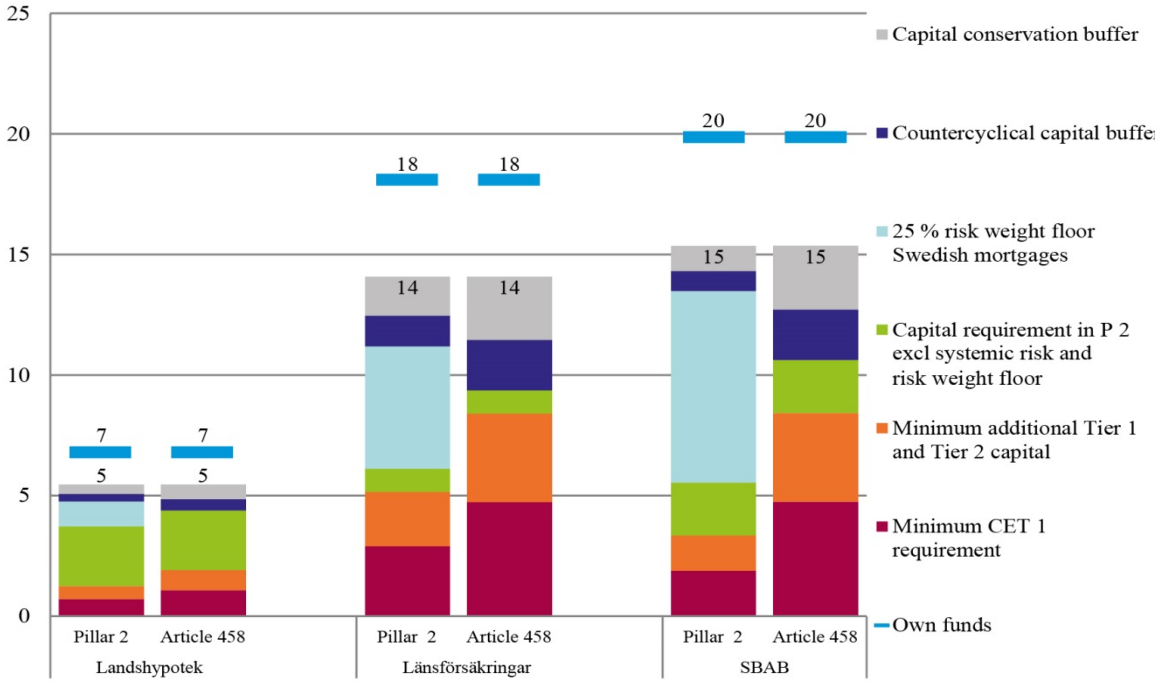
The total capital need of the credit institutions is not significantly affected as a result of FI's proposed measure. The capital requirements that previously were set through the risk weight floor for Swedish mortgages in Pillar 2 will now be set through Pillar 1. In nominal terms, FI considers the impact of the total capital requirement to be limited for all credit institutions covered by the measure. As a result of the design of the measure, the risk weight for Swedish mortgages in Pillar 1, and in turn the risk-weighted assets, will increase. The effect is that the minimum requirement increases as do the increments and buffers that are based on the risk-weighted assets. At the same time, there is an equivalent decrease in the capital requirement since the existing Pillar 2 requirement of 25 per cent for mortgages is removed. In absolute figures, the difference is negligible. Diagrams 1 and 2 illustrate the impact on the total capital requirement for several of the credit institutions subject to the measure.

Diagram 1. Impact on the total capital requirement (SEK billion)



Note: Based on the capital requirements as per Q4 2017.

Diagram 2. Impact on the total capital requirement (SEK billion)

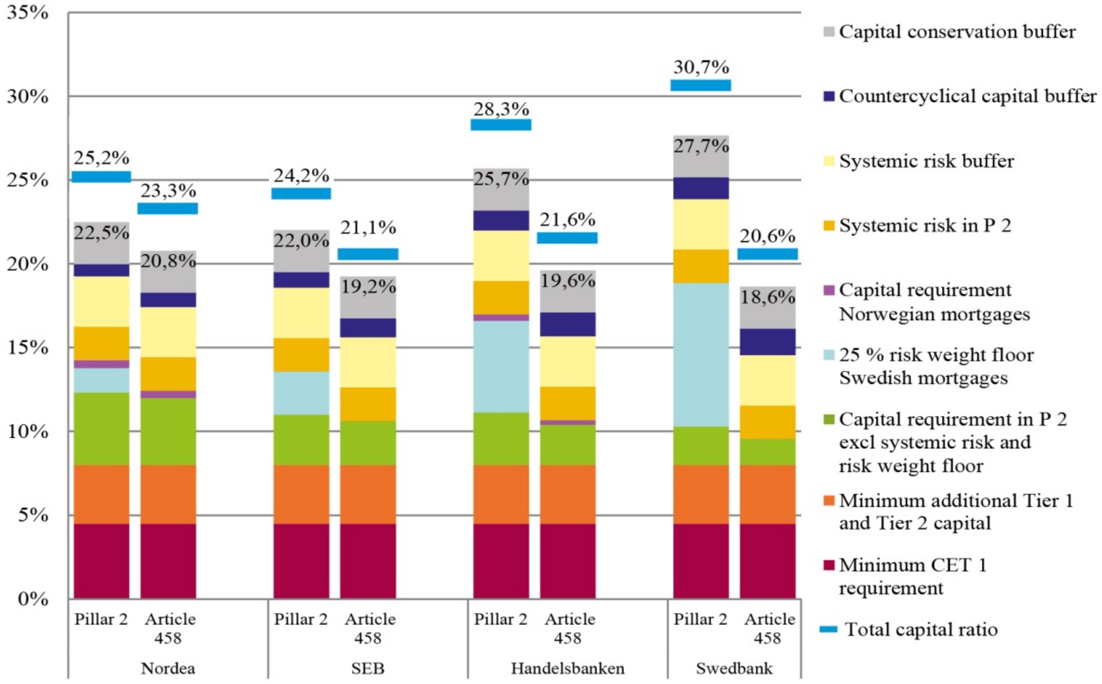


Note: Based on the capital requirements as per Q4 2017.

The total capital requirement expressed as a per cent of the risk-weighted assets will decrease, however, as a result of FI's proposed measure (see Diagrams 3 and 4). This decrease is primarily an effect of removing the risk weight floor for mortgages from Pillar 2 and instead increasing the risk-weighted exposure amount, i.e. the denominator in the capital ratio. The size of the effect for each credit institution is dependent on the percentage of Swedish mortgages in the balance sheet. The credit institutions that have a relatively high percentage of Swedish mortgages will experience a more tangible decrease than credit institutions with more diversified operations. The remaining Pillar 2 requirements as a whole will decrease when expressed as a per cent following an increase in the risk weighted assets. The total effect is also dependent on the impact of the countercyclical buffer requirement, which can vary for each credit institution.

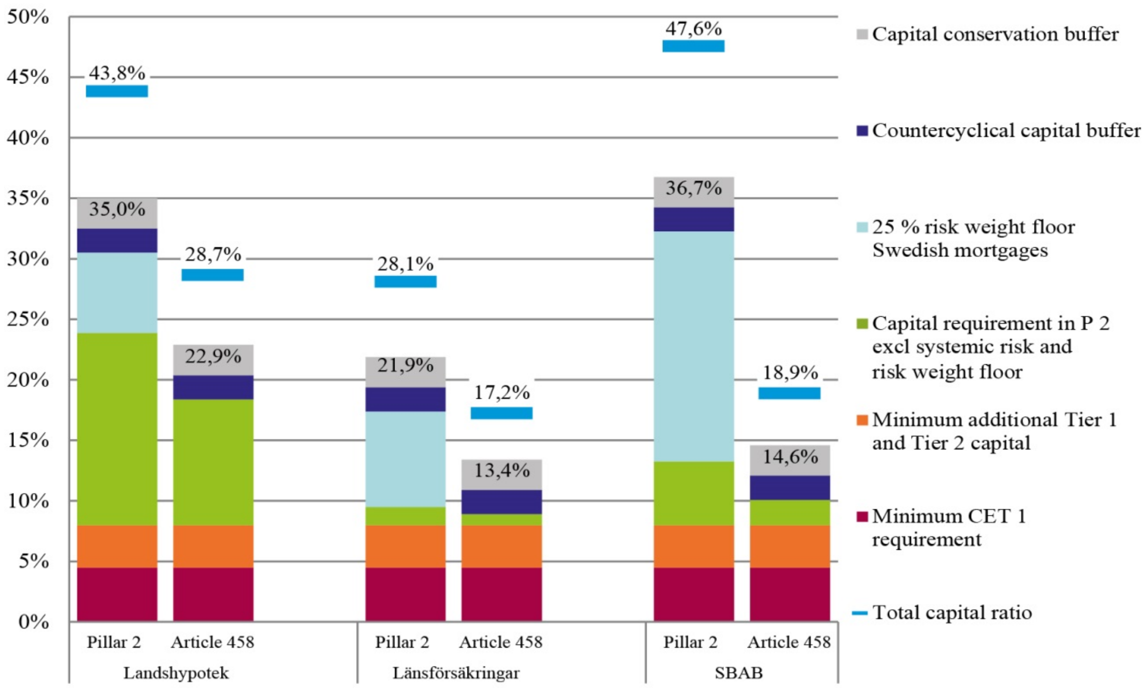
The same reasoning applies to the credit institutions' reported capital ratios. These will decrease when the risk-weighted assets increase as a result of higher risk weights for Swedish mortgages in Pillar 1. This is also presented in Diagrams 3 and 4, which show that the total capital ratios are decreasing. However, it is important to note in this context that the credit institutions' possibilities for meeting the total capital requirement are not affected.

Diagram 3. Impact on the total capital requirement (per cent of risk-weighted assets)



Note: Based on the capital requirements as per Q4 2017.

Diagram 4. Impact on the total capital requirement (per cent of risk weighted assets)



Note: Based on the capital requirements as per Q4 2017.

FI has noted that the proposed measure has a direct impact on FI's supervisory capital assessment regarding the capital requirement for credit-related concentration risk.[17] This impact only affects the credit institutions that have more than 90 per cent of their total exposure amount in Sweden. For these institutions, FI makes the assessment that the capital requirement for geographic concentration risk may not be less than 8 per cent of the capital requirement for credit risk in Pillar 1. FI does not intend to allow the capital requirement for geographic concentration risk to increase as a result of an increased capital requirement for credit risk in Pillar 1. Within the framework for the information request for SREP, FI intends to adjust the requirements for what shall be reported as a basis for FI's supervisory capital assessment of the credit institutions' capital requirement for credit-related concentration risk.

In summary, FI's proposed measure has a negligible effect on the capital requirements in SEK due to its design, which aims to keep the same capital requirements in nominal terms as the current requirements. The measure means that the requirement continues to be met with a high percentage of CET 1 capital. It furthermore ensures that Swedish credit institutions even in the future will have equally high capital buffers for systemic risks linked to Swedish mortgages as under the current capital requirements. Swedish credit institutions will thus continue to be resilient. The measure, however, will reduce the capital requirements and capital levels expressed in per cent of risk-weighted assets. This is only a technical effect since the impact on the Swedish credit institutions' capital levels and capital requirements in SEK is negligible. In practice, this means that the capital requirements that previously were set through the risk-weight floor for Swedish mortgages in Pillar 2 will now be set through Pillar 1. The requirement is more or less the same, and this means that Swedish credit institutions already fulfil the requirements, regardless of how they are applied.

The proposed change in the design of the capital requirements entails that the capital requirements in Pillar 1 (and thus the risk-weighted exposure amounts) no longer only cover institution-specific credit risks, which is the case today. One consequence of the risks to the financial system in general being reflected in Pillar 1 through the Article 458 measure is that the capital ratios (the capital level as a per cent of risk-weighted assets) become less comparable between credit institutions in different countries to the extent that the systemic risk assessments differ.

3.1.1 Reduced margin to the level for automatic dividend restrictions

The risk weight floor for mortgages in Pillar 2 is not a formally decided requirement. Insofar that a formal decision has not been made, the capital requirement under Pillar 2 does not affect the level at which the automatic

[17] *FI's Methods for Assessing Individual Risk Types within Pillar 2*, May 2015, FI. https://www.fi.se/en/published/news/2015/fi-publishes-methods-for-assessing-capital-requirements-for-three-important-risk-types/.

restrictions on distributions linked to the combined buffer requirement come into effect. One consequence of introducing the risk weight floor through Article 458 of the CRR is that the share of the capital requirements in Pillar 1 will increase. This reduces the margin to the level when the automatic dividend restrictions enter into force. FI makes the assessment that Swedish credit institutions will continue to have satisfactory margins even after the measure has been implemented. FI is also able to reassess and withdraw a measure under Article 458 of the CRR, which would then apply to all credit institutions covered by the measure. This is in line with the purpose of Article 458(4), which allows a measure imposed under Article 458 to be revoked if the macroprudential or systemic risk ceases to exist. This enables FI to achieve a similar buffer function at the systemic level as with today's risk weight floor in Pillar 2.

3.2 Effects of MREL – bail-inable debt

The proposed measure can also have direct or indirect effects on regulations that lie outside of FI's direct area of responsibility. On example is the capital requirements and minimum requirements on bail-inable debt (the MREL[18] requirements). These aim to regulate the debt in credit institutions' balance sheets so the institutions can handle losses that arise and recapitalisation needs. The Swedish National Debt Office is responsible for deciding on the size of the MREL requirement. The institutions that are affected must meet the requirement as of 1 January 2018. FI has informed the Swedish National Debt Office that the proposed measure may affect the MREL requirement and principles related to it.[19]

Given the method decided by the Swedish National Debt Office, where the MREL requirements shall comprise the sum of a loss absorption amount and a recapitalisation amount, the following is an account of the effects from FI's proposed measure according to Article 458.

The Swedish National Debt Office's published method[20] for the design of the MREL requirements states which parts of the capital requirement are judged to be relevant to safeguard loss absorption and recapitalisation needs in resolution. The loss absorption amount shall be equivalent to the institution's total capital requirements, excluding the combined buffer requirement and, where applicable, macroprudential elements within the Pillar 2 requirements. The recapitalisation amount shall be the equivalent to the credit institution's

[18] Minimum Requirement for own funds and Eligible Liabilities.

[19] One example is the liabilities proportion principle. The proportion of liabilities must correspond to the size of the recapitalisation amount expressed as a per cent of a risk-weighted exposure amount. In 2018, firms affected by the liabilities proportion principle shall apply the percentage for the recapitalisation amount that has been calculated in conjunction with the Swedish National Debt Office's decision regarding the minimum requirement.

[20] *Application of the Minimum Requirement for Own Funds and Eligible Liabilities*, February 2017 (Ref. RG 2016/425), Swedish National Debt Office.

total risk-weighted capital requirements after removing the combined buffer requirement.

FI makes the assessment that a risk-weight floor for mortgages in Pillar 1 affects the MREL requirement in that the loss absorption amount increases at the same time as the recapitalisation amount decreases. This means that the total MREL requirement may decrease for the affected institutions.

3.3 Effects on the resolution fee

The management of crisis-stricken credit institutions according to the Resolution Act shall primarily consist of losses and recapitalisation costs being financed through shareholders and lenders. In extraordinary circumstances, external financing may be required. A resolution reserve has therefore been established using fees from the institutions. It can be used for an institution that is placed into resolution, for example to provide temporary financing or under extraordinary circumstances to contribute to the recapitalisation of the institution.

The resolution reserve is financed by annual fees that are paid by the credit institutions and securities companies subject to the Resolution Act.[21] The total resolution fees for one year shall amount to a percentage of the institutions' estimated fee basis, as set forth by law.[22] The total fee is then divided among the institutions. The fees for smaller institutions are set using a standardised approach, while larger institutions pay a fee in proportion to the risk the pose to the system. The risk adjustment is based on a combination of different performance indicators that, among other things, include the institutions' total risk-weighted assets.

The introduction of a risk weight floor for mortgages in Pillar 2 will not affect the total annual fee charged. However, the distribution of the fee between institutions may change since the key ratios included in the fee model will change. Because the fees charged for 2019 will be based on the 2017 year-end report, the proposed measure will not affect the resolution fee until 2020.

3.4 Effects on the fee for deposit insurance

The deposit insurance scheme contributes to strong consumer protection and financial stability. Every institution that is covered by the deposit insurance must pay an annual fee to the insurance authority. The calculation of the fee for the deposit reserve uses risk-based methods and the institutions' risk level. The

[21] The risk-adjusted fee is calculated in accordance with Commission Delegated Regulation (EU) 2015/63 of 21 October 2014 supplementing Directive 2014/59/EU of the European Parliament and of the Council with regard to ex ante contributions to resolution financing arrangements.

[22] The fee for 2018 is 0.125 per cent. The fee basis consists of the sum of the institutions liabilities, following deductions for guaranteed deposits, and other debt items.

aim of the fee model is – in addition to financing the costs of the deposit insurance over time – to contribute to stronger incentives for institutions to reduce their risk profile.

The internal distribution of the fees for the deposit insurance, much like the resolution fee, is also steered by a number of key ratios that may be affected by FI's proposal. The fees of individual institutions may therefore change, but not the total fee charged for the deposit insurance.[23]

3.5 Impact on competition and the market

By continuing to apply the risk weight floor to Swedish mortgages but in a different form than today, the proposed measure contributes to maintaining a level playing field and equal capital requirements for the credit institutions that are active on the Swedish mortgage market. Unjustified changes to the capital requirements that risk arising as a result of institutions changing their legal domicile are limited in that FI applies measures that other Member States can more easily reciprocate. FI makes the assessment that a level playing field is positive for the risk management of the Swedish mortgage market.

FI also makes the assessment that the measure will have a limited impact on the market. First, the proposed measure has a negligible effect on the capital requirements in SEK due to its design, which aims to keep the same capital requirements in nominal terms as the current requirements. The affected credit institutions already fulfil the requirements, which will continue to be met with a high percentage of CET 1 capital. Swedish credit institutions will therefore even in the future have equally high capital buffers for systemic risks linked to Swedish mortgages as under the current capital requirements and thus continue to be resilient. Second, FI is also able to reassess and withdraw a measure under Article 458 of the CRR if the macroprudential or systemic risk ceases to exist. This enables FI to achieve a similar buffer function at the systemic level as with today's risk weight floor in Pillar 2.

3.6 Impact on society and consumers

By maintaining capital requirements for all credit institutions active on the Swedish mortgage market, FI ensures that the affected credit institutions remain resilient. A credit institution that is well capitalised and has good earnings will find it easier to carry credit losses and to a greater extent be able to provide households and non-financial firms with loans even during periods of stress. This contributes to a stable development in the real economy and stability in the Swedish financial system, which benefits consumers and society at large.

[23] The total fee charged amounts to 0.1 per cent of the institutions' total guaranteed deposits.

The proposed measure will not affect the total capital level in nominal terms, and there is no direct impact on the level of capital in the banking system. FI therefore makes the assessment that the economic costs, for example in the form of the impact on lending rates to households and non-financial firms, should be negligible.

3.7 Impact on Finansinspektionen

The proposed measure is not considered to entail any major changes to FI's tasks or area of responsibility since the follow-up and impact analysis should be able to be conducted as part of the regular supervisory activities.