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Amendment to Finansinspektionen's regulations (FFFS 2014:12) regarding prudential requirements and capital buffers

Summary

Finansinspektionen introduces a waiver from the requirements in Article 129(1) (c) of the Capital Requirements Regulation[1] by means of an amendment to Finansinspektionen's regulations (FFFS 2014:12) regarding prudential requirements and capital buffers.

Article 129(1) (c) of the Capital Requirements Regulation contains rules for preferential treatment, in terms of capital adequacy, of holdings in covered bonds. The provision sets out which requirements are imposed on exposures to credit institutions that collateralise a covered bond in order to enable preferential treatment. In Sweden, such exposures as those referred to in Article 129(1) (c) are primarily derivatives entered by issuers of covered bonds with the purpose of managing interest rate and foreign exchange risk.

According to Article 129(1), final paragraph of the Capital Requirements Regulation, the competent authority may partly waive the application of the requirement ensuing from Article 129(1) (c) and instead allow credit quality step 2 for an exposure equalling up to 10 per cent of the nominal amount of issued covered bonds.

Finansinspektionen now introduces this possibility of a waiver. The aim is to avoid the concentration problems that can arise on the Swedish market if all issuers of covered bonds only attempt to have exposures to a limited number of counterparties that meet credit quality step 1.

The regulatory amendment enters into force on 31 March 2015.

[1] 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.

Contents

Summary 1
1 Merits 3
1.1 Objective of the regulation 3
1.2 Current and forthcoming regulations..3
1.2.1 Capital Requirements Regulation..3
1.2.2 EBA's opinion on the Danish supervisory authority's introduction of the waiver 4
1.2.3 Swedish regulation of covered bonds..5
1.2.4 Summary of the regulations 5
1.3 Regulatory alternative..5
1.4 Legal basis 6
1.5 Preparation of the matter 6
2 Motivation and considerations 7
2.1.1 Covered bonds..7
2.1.2 Issuers' exposures to credit institutions 8
2.1.3 The credit ratings of Swedish credit institutions..9
2.1.4 Concentration problems 10
2.1.5 Overall assessment 11
2.2 Scope 12
3 Consequences of the proposal 12
3.1 Consequences for institutions..13
3.2 Consequences for society and consumers 16
3.3 Consequences for Finansinspektionen..16

1 Merits

1.1 Objective of the regulation

The objective of the waiver of Article 129(1) (c) 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 of the amendment of Regulation (EU) No 648/2012 (the Capital Requirements Regulation) now introduced by Finansinspektionen is to avoid potential concentration problems. If the waiver is not introduced, there is a risk that all issuers of covered bonds on the Swedish market may have their exposures to a limited number of credit institutions with the purpose of meeting the requirements of the Article 129(1) (c).

1.2 Current and forthcoming regulations

1.2.1 Capital Requirements Regulation

The Capital Requirements Regulation contains provisions regarding capital adequacy, which in simplified terms means that own funds shall cover the own funds requirements. When calculating the capital requirements for credit risks, holdings in covered bonds, in accordance with Article 129 of the Capital Requirements Regulation, may have preferential treatment in terms of risk weight, provided that certain conditions are met. The preferential treatment involves the capital requirement for the holding being between two and five times less than what would otherwise have been the case.[2]

In order to be eligible for such preferential treatment, the covered bond must be collateralised by one of the assets listed in Article 129. The requirements for exposures to credit institutions are addressed in 129(1) (c).

A requirement for preferential treatment is that, insofar that an exposure in the form of a covered bond is collateralised by an exposure to a credit institution, the credit institution must have a credit rating entailing that it meets the requirements for credit quality step 1. Credit quality step 1 equals a credit rating of AA or better.[3]

According to Article 129(1), final paragraph of the Capital Requirements Regulation, the competent authority may partly waive the application of the

[2] In the standardised approach, the risk weight is 10 per cent for a preferentially treated covered bond with a credit rating equalling credit quality step 1. If the bond does not meet the preferential treatment requirements, it is the credit rating of the issuer that determines the risk weight. This will be 20 per cent for a credit rating equalling credit quality step 1, and 50 per cent for a credit rating equalling credit quality step 2. In the fundamental internal ratings-based approach, Loss Given Default (LGD) will be four times lower if the bond meets the preferential treatment requirements.

[3] https://www.eba.europa.eu/documents/10180/16166/4+Ausust+2006_Mapping.pdf

requirement ensuing from Article 129(1) (c) and allow credit quality step 2[4] for an exposure equalling up to 10 per cent of the nominal amount of issued covered bonds. Such a waiver may occur following consultation with the European Banking Authority (EBA) and provided that the competent authority – Finansinspektionen in this case – can demonstrate that the requirement for credit quality step 1 involves substantial concentration problems in the Member State. Following the consultation, the EBA publishes an opinion regarding the intention of the competent authority to introduce the waiver.

Article 496(2) of the Capital Requirements Regulation contains a transition rule for the own funds requirement for covered bonds. The transition rule sets out that until 31 December 2014 inclusive, exposures to credit institutions that had a risk weight of 20 per cent under previous national law shall be considered to qualify for credit quality step 1 when applying Article 129(1) (c). Under previous Swedish regulations[5] exposures to all Swedish credit institutions had a risk weight of 20 per cent in the standardised approach, as a consequence of the home country Sweden belonging to credit quality step 1. For Swedish firms, the transition rule has thus meant that the requirements regarding credit quality step 1 for exposures to credit institutions in Article 129(1) (c) need not in practice have been applied until 1 January 2015.

1.2.2 EBA's opinion on the Danish supervisory authority's introduction of the waiver

The Danish supervisory authority, Finanstilsynet, has, following consultation with EBA, introduced the waiver in Article 129(1) of the Capital Requirements Regulation. The consultation ended by EBA publishing its opinion of Finanstilsynet's intention to introduce the waiver.[6] EBA finds it warranted to introduce the waiver because the requirements in Article 129(1) (c) could otherwise cause substantial concentration problems in Denmark, and according to the EBA the consequences thereof include a deterioration in competition on the Danish financial market.

In its opinion, EBA clarifies which type of exposures to credit institutions are covered by Article 129(1) (c). According to the opinion, derivatives shall be considered such exposures, which was not entirely clear beforehand.

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[4] Credit quality step 2 is equivalent to the credit ratings A+, A and A- on Standard and Poor's credit rating scale.
[5] See section 10 of the Capital Adequacy and Large Exposures Ordinance (2006:1533) and Chapter 16, section 12 of Finansinspektionen's regulations and general guidelines (FFFS 2007:1) regarding capital adequacy and large exposures.
[6] EBA/Op/2014/13 – Opinion of the European Banking Authority on the partial waiver of Article 129 (1) (c) of the CRR. Published on EBA's website on 19/12/2014.

1.2.3 Swedish regulation of covered bonds

Covered bonds are regulated by the Covered Bonds (Issuance) Act (2003:1223) – the CBIA – and Finansinspektionen’s regulations and general guidelines (FFFS 2013:1) regarding covered bonds.

According to Chapter 3, section 2 of the CBIA, exposures to credit institutions in the form of cash, investments, receivables and guarantees may in certain circumstances be included in the cover pool as substitute assets. For example, an issuer may not use bonds issued by credit institutions as substitute assets unless Finansinspektionen, following application, has approved this. According to the same paragraph, the share of substitute assets may constitute no more than 20 per cent of the cover pool.

Issuers of covered bonds may also have exposures to credit institutions in the form of derivatives. In Chapter 4 of Finansinspektionen’s regulations and general guidelines regarding covered bonds, there are provisions regarding which terms and conditions apply to derivative contracts. There are for example requirements that the counterparty in the derivative contract, at the time the contract was entered, shall have a credit rating no lower than A-[7], which equates to credit quality step 2.

1.2.4 Summary of the regulations

The transition rule in Article 496(2) of the Capital Requirements Regulation ceased to apply on 1 January 2015. Exposures to credit institutions that collateralise covered bonds shall therefore meet the requirements set out in Article 129(1) (c), if such bonds, also going forward, shall be subject to preferential treatment as regards capital adequacy. The EBA’s opinion of Finanstilsynet’s decision in December 2014 sets out that derivatives are covered by the requirements in Article 129(1) (c).

Finansinspektionen has, under the Capital Requirements Regulation, the possibility of partly waiving application of Article 129(1) (c) and allowing credit quality step 2 for up to 10 per cent of the total exposure for the nominal amount of the issuing institution’s outstanding covered bonds. This applies provided that Finansinspektionen consults with EBA and can demonstrate that substantial potential concentration problems are thus avoided.

1.3 Regulatory alternative

Finansinspektionen has considered various possibilities of introducing the waiver. The authority considers that the possibility of the waiver ensuing from Article 129(1), final paragraph of the Capital Requirements Regulation is not of such a nature that it, without being governed in regulations, could be

[7] A- according to Standard and Poor’s credit rating scale equates to the credit ratings A3 on Moody’s scale and A- on Fitch’s scale.

implemented by decisions in each individual case. Furthermore, Finansinspektionen considers that waiving that which follows from the Capital Requirements Regulation, which is directly applicable in Sweden, cannot be introduced through general guidelines.

Because Finansinspektionen is authorised to introduce the waiver through regulations (see section 1.4), the waiver is introduced in Finansinspektionen's regulations (FFFS 2014:2) regarding prudential requirements and capital buffers (the prudential requirement regulations).

1.4 Legal basis

According to Article 129(1), final paragraph of the Capital Requirements Regulation, Finansinspektionen has the possibility of waiving the application of Article 129(1) (c). However, a condition for doing so is, according to the same Article, that this occurs following consultation with EBA and that Finansinspektionen can demonstrate substantial potential concentration problems due to the application of the requirement in Article 129(1) (c). Finansinspektionen is of the opinion that substantial concentration problems can arise if the waiver is not introduced and has thus initiated consultation with EBA.

Even though the Capital Requirements Regulation is clear in that the competent authorities, in certain circumstances, may introduce the waiver, Finansinspektionen requires authorisation from the Government to do so in regulations. According to Chapter 10, section 1 of the Special Supervision of Credit Institutions and Investment Firms Act (2014:968), the Government, or the authority designated by the Government, may issue regulations that supplement the provisions of the Capital Requirements Regulation regarding the calculation of the own funds requirement and own funds, and covered bonds.

Furthermore, the Government has, in section 16 of the Special Supervision and Capital Buffers Ordinance (2014:993), authorised Finansinspektionen to issue regulations that supplement the provisions of the Capital Requirements Regulations regarding the calculation of the own funds requirement and own funds, and covered bonds.

In light of this, Finansinspektionen is of the opinion that it is authorised to introduce the waiver in the regulations of the authority.

1.5 Preparation of the matter

Finansinspektionen has, in the work on preparing the regulations, consulted with EBA regarding introducing the waiver. EBA finds that

Finansinpektionen’s decision to introduce the waiver is justified, because concentration problems could otherwise arise.[8]

In light of the fact that the regulatory project has a limited scope and that the regulatory amendment does not in practice bring about any change in relation to the transition rule in the Capital Requirements Regulation that applied through 31 December 2014, no external reference group has been appointed. However, Finansinspektionen has been in regular contact with the Swedish Bankers’ Association, through the industry organisation Association of Swedish Covered Bond Issuers[9] (ASCB), during the process of introducing the waiver.

A proposal for amended regulations was submitted to consultation on 2 February 2015 together with a consultation memorandum. During the consultation period, Finansinspektionen held an open consultation meeting with industry representatives and other stakeholders. Written feedback on the proposal has been received from the Regulation Board, the Riksbank and ASCB. The Association of Swedish Finance Houses supports the regulatory amendment. The Swedish Investment Fund Association, the Swedish National Debt Office and the Swedish National Savings Banks Organisation have no objections to the regulatory amendment. The Swedish Competition Authority and FAR (Swedish institute for the accountancy profession) see no need to express an opinion on the matter.

Following the consultation, Finansinspektionen has taken the responses of the consulted bodies into consideration. The main points of feedback to the proposal are provided and addressed in section 2.

The regulatory amendment will enter into force on 31 March 2015.

2 Motivation and considerations

2.1.1 Covered bonds

Covered bonds are interest-bearing securities which, following authorisation from Finansinspektionen, are issued by banks or credit market companies. The holders of the bonds have a special right of priority to a cover pool if the issuer is subject to foreclosure or enters into bankruptcy.

Covered bonds are used to fund a substantial part of the lending of Swedish credit institutions. The total outstanding amount of covered bonds is currently around SEK 2,000 billion. This equates to around half of Swedish gross

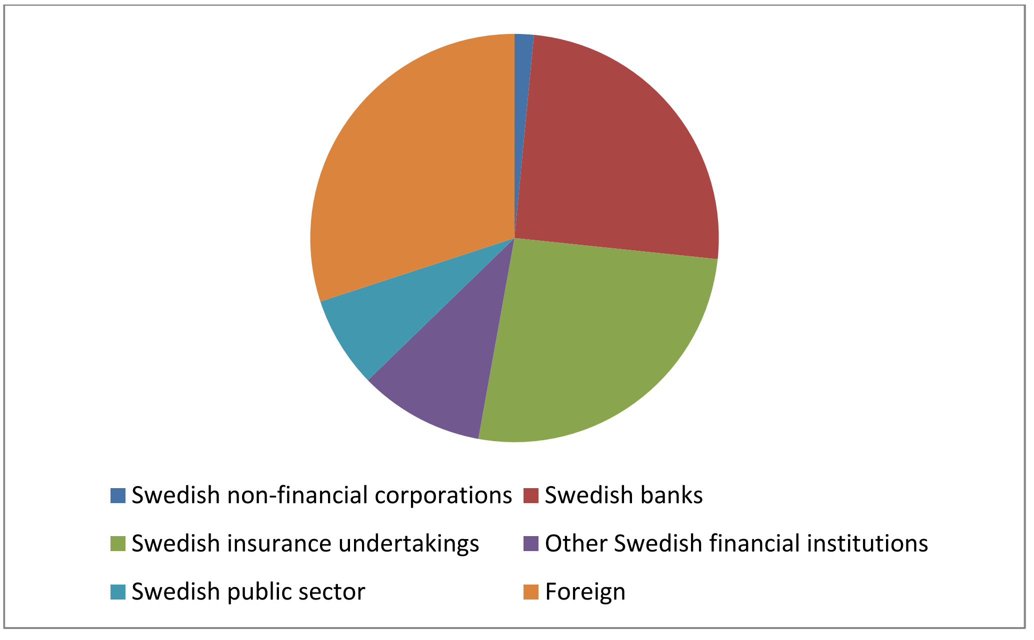
[8] The opinion was published on EBA’s website on 5 March 2015. https://www.eba.europa.eu/-/eba-finds-swedish-waiver-on-covered-bonds-justified
[9] The Association of Swedish Covered Bond Issuers (ASCB) is an industry organisation for Swedish issuers of covered bonds. The Swedish Bankers’ Association serves as ASCB’s secretariat.

domestic product (GDP). Eight credit institutions are currently authorised to issue Swedish covered bonds. They are Landshypotek, Länsförsäkringar Hypotek, Nordea Hypotek, SCBC, SEB, Skandiabanken, Stadshypotek and Swedbank Hypotek.[10] For these credit institutions, covered bonds are an important source of funding.

Diagram 1 illustrates the breakdown of ownership of Swedish covered bonds between different categories. Swedish banks own 25 per cent of the total volume of issued bonds, while Swedish insurance companies own 26 per cent. A large proportion of the covered bonds are owned by foreign investors.

The cover pool for Swedish covered bonds mainly contains mortgages for homes. Loans that finance commercial properties and agricultural properties can also be included in the cover pool. Besides mortgage loans, substitute assets are permitted in the cover pool in accordance with Chapter 3, section 2 of the CBIA. These can e.g. consist of government bonds, other covered bonds or cash.

Diagram 1. Breakdown of ownership of Swedish covered bonds, second quarter 2014. Source: Statistics Sweden.



2.1.2 Issuers' exposures to credit institutions

The exposures that secure covered bonds sometimes include exposures to credit institutions in the form of cash, other substitute assets or derivatives. Out of these, derivatives account for the majority of the exposures to other credit institutions. It is derivatives that are the main reason why Finansinspektionen is implementing the regulatory amendment.

[10] Stadshypotek and SCBC are the mortgage institutions of, respectively, Svenska Handelsbanken and SBAB.

The issuers use derivatives to strike a healthy balance between assets and liabilities. According to Chapter 3, section 9 of the CBIA, all payment flows in bonds, derivatives and liabilities shall be such that the issuer can at all times honour the payment obligations ensuing from the issued bonds. Depending on how the terms for interest rates and foreign exchange diverge between the issued bonds and the assets in the cover pool, the issuers use derivatives to a greater or lesser extent for their risk management.

The assets in the cover pool often have a fixed interest term profile that differs from that of the issued covered bonds. This imbalance between assets and liabilities is normally redressed by means of the issuer of the bond entering fixed income derivatives.

Issuers of covered bonds also issue bonds in a currency[11] other than that of the cover pool. Around 25 per cent of the total nominal amount of all issued covered bonds in Sweden are issued in a currency other than Swedish kronor.[12] Mortgages for homes denominated in Swedish kronor are often included in the cover pool for Swedish covered bonds, issued in foreign currencies. This poses a foreign exchange risk, which issuers manage by entering foreign exchange derivatives.

The Riksbank expresses in its consultation response that it finds that the way in which Swedish issuers of covered bonds currently work with derivatives does not contribute to financial stability. Factors mentioned by the Riksbank that do not promote financial stability are the fact that a large volume of derivatives are entered between the issuer and the parent bank (i.e. they are intra-group derivatives), and the use of derivative clauses with credit rating references. Finansinspektionen has not taken these circumstances into account in its work on introducing the waiver, because they are not directly affected by the regulatory amendment.

2.1.3 The credit ratings of Swedish credit institutions

Official credit ratings from external credit rating institutions for the ten largest Swedish credit institutions are shown in Table 1. Out of these credit institutions, it is the four largest that are mainly considered able to act as derivative counterparties to issuers of covered bonds. Although there are credit institutions in Sweden outside of this group that meet the requirements for credit quality step 1 (Kommuninvest and Svensk Exportkredit), these credit institutions do not have the type of operations, and are not sufficiently large, to assume the role of derivative counterparty for the entire market in this context.

[11] Primarily euro.
[12] http://www.ascb.se/Pages/4_Marketinformation.aspx

As shown in the table, two of the larger credit institutions currently have a credit rating equalling AA- or above and hence meet the requirements for credit quality step 1.

Table 1. The credit ratings issued by external credit rating institutions for the ten largest Swedish credit institutions in January 2015

Banks	*S & P*	*Moody's*	*Fitch*
Nordea Bank AB	AA-	Aa3	AA-
Svenska Handelsbanken AB	AA-	Aa3	AA-
Swedbank AB	A+	A1	A+
Skandinaviska Enskilda Banken AB	A+	A1	A+
Länsförsäkringar Bank AB	A-	A3	-
SBAB Bank AB	A	A2	-
Skandiabanken AB	-	A3	-
Landshypotek AB	A-	-	A-
Kommuninvest AB	AAA	Aaa	-
Svensk Exportkredit AB	AA+	Aa1	-

2.1.4 Concentration problems

The requirements for credit quality step 1 for exposures to credit institutions in Article 129(1) (c) of the Capital Requirements Regulation mean that issuers of covered bonds are limited to only two Swedish derivative counterparties for hedging deficient matching between liabilities and assets in order for the issued covered bonds to be eligible for preferential treatment under 129(1) (c) of the Capital Requirements Regulation. In Finansinspektionen's opinion, concentration problems arise if the issuers only use two derivative counterparties.

Such concentration could distort competition such that the few credit institutions with a credit rating equalling credit quality step 1 would have a market advantage. These credit institutions could greatly influence pricing of such derivatives, which would be harmful for competition.

Furthermore, a high concentration of derivative counterparties in a key part of the Swedish financial system could pose risks to financial stability. This is because there would be a great risk of contagion effects in the event of a default. There is also the risk of one of these credit institutions sometime in the future no longer fulfilling the requirements for credit quality step 1. Given that so few credit institutions currently meet these requirements, such an event could also cause shocks on the market, irrespective of whether or not the credit institution is on the brink of default. Because of its size, the Swedish covered bond market is considered systemically important for Sweden. Confidence in Swedish covered bonds could decline if the covered bonds do not meet the terms of Article 129 of the Capital Requirements Regulation.

It is important to point out that, when the waiver is introduced, this involves lowering the requirements that covered bonds must meet to be eligible for preferential treatment. This results in Swedish covered bonds that are eligible for preferential treatment becoming exposed to a greater extent to credit institutions with poorer credit ratings than would otherwise have been the case. Ultimately, this could lead to a greater risk of losing money on holdings in such covered bonds. Finansinspektionen intends to regularly evaluate whether potential concentration problems continue to exist in relation to the requirements of Article 129(1) (c) of the Capital Requirements Regulation. If at any time in the future the authority finds that this is not the case, the national waiver can be removed.

The Riksbank states in its consultation response that it finds Finansinspektionen should consider alternative methods of managing concentration problems if the waiver is also required going forward. Finansinspektionen intends to address the matter in line with the legislation prevailing at the time in question and with due consideration for market functioning.

2.1.5 Overall assessment

Finansinspektionen finds that waiving Article 129(1) (c) of the Capital Requirements Regulation is justified, with account taken of the credit ratings of Swedish credit institutions and the importance of the covered bond market to the financial system. In this way, potential concentration problems can be avoided on this market.

The Riksbank's consultation response sets out that the bank shares Finansinspektionen's assessment that, if the waiver is not introduced, this could have negative consequences, such as heightened concentration risk.

The waiver means that exposures to credit institutions with a credit rating equalling credit quality step 2 are permitted to collateralise covered bonds subject to preferential treatment. Total exposure of this type may amount to a maximum of 10 per cent of the nominal amount of the issuer's issued covered bonds. *ASCB* proposes in its consultation response that Finansinspektionen, in the decision memorandum, clarifies how this requirement stands in relation to the original requirement in Article 129(1) (c), regarding the permitted volume of exposures to credit institutions with credit quality step 1. Finansinspektionen's opinion is that the waiver, with an exposure limit of 10 per cent, is to apply within the bounds of the original requirement in Article 129(1) (c) with an exposure limitation of 15 per cent. Covered bonds subject to preferential treatment under Article 129 may thus, once the waiver is introduced, be collateralised by exposures to credit institutions with credit quality step 1 or credit quality step 2 to an amount equalling 15 per cent of the nominal amount of issued bonds, of which a maximum of 10 per cent may be to credit institutions with credit quality step 2.

In its consultation response, ASCB also proposes that Finansinspektionen clarifies how the requirement will be applied for issuers with several cover pools that collateralise different covered bonds. ASCB finds that the requirements in Article 129(1) are to be understood by cover pool if the issuer has several different cover pools that collateralise different bonds. Finansinspektionen finds that the first paragraph of Article 129(1) of the Capital Requirements Regulation sets out that ASCB's interpretation is correct, and that no further clarification is thus needed. The requirements apply to exposures that collateralise covered bonds, and the nominal amount of the issuer's covered bonds shall thus be understood as only applying to the bonds collateralised by the exposure in question.

Although the waiver indirectly involves a certain easing of the covered bond regulations, stringent demands are imposed on Swedish covered bonds, through the CBIA and Finansinspektionen's regulations and general guidelines regarding covered bonds.

As described above, it is primarily problems in derivative exposures that lead to Finansinspektionen introducing the waiver. Because it is unclear whether it is permitted, under the Capital Requirements Regulation, to limit the waiver to derivative exposures alone, the waiver applies to all exposures to credit institutions. In terms of covered bonds, the CBIA also includes rules regarding which types of exposure may collateralise covered bonds, which is a limitation in itself. An issuer may not for example use bonds issued as substitute assets by credit institutions unless Finansinspektionen, following application, has approved this.

2.2 Scope

The prudential requirement regulations encompass banking companies, savings banks, members' banks, credit market companies, credit market associations and investment firms. The provisions also apply to payment institutions, Svenska skeppshypotekskassan, fund management companies authorised for discretionary portfolio management in financial instruments and alternative investment fund (AIF) managers authorised to conduct discretionary portfolio management

3 Consequences of the proposal

Finansinspektionen describes below the consequences that the regulatory amendment is expected to have for firms, society, consumers and Finansinspektionen.

The Regulation Board points out, in its consultation response, several deficiencies in Finansinspektionen's analysis of the consequences of the regulatory amendment for firms. The Regulation Board finds that the analysis lacks a description of the size of the firms concerned, an estimation of the administrative expenses and justification as to why no particular consideration is given to small firms. Finally, the Regulation Board finds it remarkable that Finansinspektionen has not been able to estimate in more detail the savings that the regulatory amendment is assessed to involve in terms of non-transpired financial expenses.

Finansinspektionen has, having taken the Regulation Board’s comments into account, supplemented the consequence analysis. In terms of the financial savings to which the proposal is expected to lead, Finansinspektionen has opted to illustrate these for a fictitious issuer in certain specific situations. Estimating the aggregate saving for all issuers is practically impossible, because the actual cost that would arise if the regulatory amendment were not implemented depends too greatly on which choices the issuers would make. Finansinspektionen has no possibility of accurately predicting how issuers would act. However, illustrating how different choices would be reflected as increased financial expenses for a fictitious issuer can nevertheless give an idea of the scope of the costs.

The waiver means reduced requirements for exposures to credit institutions that secure covered bonds, which are subject to preferential treatment. The requirements are reduced in such a way that such exposures may to a certain extent be to credit institutions with a credit rating equalling credit quality step 2. This results in a lower credit rating requirement for such exposures than what would otherwise be the case.

If the regulation were not put in place, concentration problems may arise because issuers of Swedish covered bonds would only have two eligible derivative counterparties to appoint currently. This applies provided that the issuers wish the bonds to meet the requirements imposed in Article 129 of the Capital Requirements Regulation. Finansinspektionen finds it important for the market, and ultimately for financial stability, that such concentration problems are avoided.

In Finansinspektionen’s opinion, no specific communication initiatives are needed when the regulations come into effect. The proposal does not involve any change to which Swedish credit institutions may be derivative counterparties for issuers of covered bonds compared to the transition rule that applied previously. Hence, the regulatory amendment does not involve any practical difference in how the requirement for the assets that collateralise covered bonds is applied in Sweden.

3.1 Consequences for institutions

Those affected by the regulatory amendment are the firms encompassed by the prudential requirement regulations (see section 2.2) and which invest in such bonds. Issuers of Swedish covered bonds are also indirectly affected by the regulation.

In total, the regulations affect over 300 firms. Their size varies from banking groups with balance sheet totals equalling around SEK 6,500 billion, to smaller investment firms with balance sheet totals of a few million SEK.

In Finansinspektionen's opinion, the introduction of the regulatory amendment will not involve any substantial administrative expenses, either for investors or for issuers of covered bonds. This is because the regulatory amendment only involves a change to the requirement level. No new requirement is being introduced, and no existing requirement is being abolished. Whether or not the waiver is introduced, investors in covered bonds thus need to verify the credit rating of those acting as derivative counterparty to the issuer. For the same reasons, small firms are not considered to be affected by the proposal. The proposal does not entail any firm – large or small – having to adapt its operations.

For the issuers, the regulatory amendment is not considered to lead to any financial expenses, because the regulation means that the same derivative counterparties previously used can continue to be counterparties. With the introduction of the waiver, costs can thus be avoided because it could be very costly to find new counterparties and renegotiate existing contracts to meet the requirements in Article 129(1) (c) of the Capital Requirements Regulation. Estimating this saving in terms of SEK is very difficult, but for certain firms it could be a matter of millions, as illustrated in the example below.

The regulatory change is not considered to trigger any financial expenses for credit institutions with holdings in Swedish covered bonds either. However, a scenario in which regulation is not introduced would make it harder for the covered bonds to meet the requirements for preferential treatment in terms of capital adequacy. It could potentially lead to a share of the Swedish covered bonds no longer meeting these requirements. Hence, credit institutions with holdings in these bonds would have a higher capital requirement. In Finansinspektionen's opinion, the bonds that do not meet the requirements would therefore be more difficult to issue, and investors would want a higher return for them. That would bring about increased financial expenses for the issuers in the form of more expensive funding.

The scope of potential expenses will now be highlighted for a fictitious issuer of Swedish covered bonds. The issuer is a firm with a credit rating equalling credit quality step 2. Its total issued volume of covered bonds is SEK 500 billion, and the latter have a credit rating equalling credit quality step 1. In order to fulfill CBIA's requirements of balance between assets and liabilities, the issuer has entered foreign exchange derivatives at a nominal amount of SEK 125 billion, and fixed income derivatives at a nominal amount of SEK 150 billion. The counterparty of the issuer in the derivatives is another firm in the same group and with the same credit rating.

If the regulatory amendment were not introduced, this issuer would be faced with two choices. Either, the issuer attempts to find a new derivative counterparty that meets the requirement for credit quality step 1, or the issuer keeps the same derivative counterparty. In the latter case, the covered bonds of the issuer lose the eligibility for preferential treatment in terms of capital adequacy.

The greatest expense of the firms that would need to renegotiate their derivative contracts is that their new derivative counterparties could request an extra risk premium, in addition to the market price. A low estimate of the risk premium for both foreign exchange derivatives and fixed-income derivatives is that it would be 2 basis points[13] above the interest rate paid by the issuer in the derivative. For the fictitious issuer with a total derivative volume of SEK 275 billion, this would entail an annual expense of SEK 55 million. In this context, it is worth noting that the cost largely depends on the conditions on which the derivatives were entered. If this occurs in stressed market conditions, with many issuers simultaneously attempting to enter derivatives at high nominal amounts, the risk premium will be multiple times higher. As indicated above in the memorandum, there are only two credit institutions with credit quality step 1 that are considered to be relevant as derivative counterparties to issuers of covered bonds. This high concentration would probably lead to weak competition, which could push the risk premium up further.

If the fictitious issuer opts to keep its previous derivative counterparty, financial expense will be incurred due to more expensive funding for the issuer. Assume that an average firm affected by the Capital Requirements Regulation has a required return on equity equal to 10 per cent and a total common equity Tier 1 capital requirement of 9.3 per cent of the risk-weighted amount[14]. If the firm invests in one of the fictitious issuer’s covered bonds that is subject to preferential treatment, the risk-weighted amount for the investment in the standardised approach is, as described above, 10 per cent of the nominal amount. This entails that the part of the firm’s annual required return on the investment deriving from the capital cost will be 9.3 basis points. If all else were equal, the increase to the risk-weighted amount to 50 per cent of the nominal amount, which would be the consequence of the issuer’s bonds losing their preferential treatment, would lead to an increase in required return of 37.2 basis points. Because 25 per cent of Swedish covered bonds are owned by Swedish banks affected by the Capital Requirements Regulation, it is probable that the increased required return would affect the price of covered bonds. The effect would have an impact on the issuer’s funding cost for the new issue of covered bonds. If the bonds do not receive preferential treatment for one year and, during that year, the issuer issues covered bonds to an amount equalling SEK 50 billion, the extra annual funding cost would be SEK 186 million.

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[13] One basis point is 0.01 per cent.

[14] The components of this common equity Tier 1 capital requirement consist of the minimum requirement for common equity Tier 1 capital (4.5 per cent), pillar 2 risks (1.3 per cent), the countercyclical capital buffer for Sweden (1 per cent) and the capital planning buffer (2.5 per cent).

Finansinspektionen finds it clear that the introduction of the waiver potentially entails major savings for issuers of covered bonds.

3.2 Consequences for society and consumers

The purpose of the regulatory amendment is to avoid concentration problems on the Swedish financial market. A consequence of the regulatory amendment is that financial stability is strengthened, which benefits society. The covered bond market is considered systemically important to financial stability due to its size and key role in funding mortgage lending. By introducing the waiver, Finansinspektionen ensures that the requirements regarding covered bonds remain stringent, without the regulations creating new systemic risks.

The regulatory amendment is not considered to involve any costs for consumers. Not introducing the waiver could lead to increased costs for funding through covered bonds, which would ultimately affect borrowers.

3.3 Consequences for Finansinspektionen

The regulatory amendment does not involve any notable increase in Finansinspektionen's workload.