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CONSULTATION MEMORANDUM

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

FI's liquidity coverage ratio requirements in individual currencies and diversification of covered bonds in the liquidity buffer

This is a revised version of FI's memorandum FI:s pelare 2-krav på likviditetstäckningskvot i enskilda valutor *(FI Ref. 17-12809) published on 19 April 2018 (in Swedish only).*

Summary

In this memorandum, Finansinspektionen (FI) develops its view on several specific areas of the EU regulatory framework for liquidity regulation. FI clarifies which Pillar 2 requirements the authority will apply in various currencies. In conjunction with this, FI develops its view on how the requirements on diversification of the liquidity buffer's composition should be met. This memorandum provides a comprehensive overview of the requirements that Finansinspektionen places on liquidity regulation and replaces FI's memorandum *FI:s pelare 2-krav på likviditetstäckningskvot i enskilda valutor* (FI Ref. 17-12809) that was published on 19 April 2018 (in Swedish only).

A fully binding minimum requirement on the liquidity coverage ratio (LCR) of European banks through an EU delegated regulation has been in effect since 1 January 2018.

FI describes in this memorandum the assessment method it applies in its supervision of the LCR in individual currencies under the supervisory review and evaluation process (SREP) in Pillar 2[1] and its view on concentration risks in the banks' liquidity buffers. FI also clarifies its view on Pillar 2 requirements for liquidity risks in significant currencies and how FI considers the requirement on diversification of the liquidity buffer's composition of liquid assets should be met.

[1] Pillar 2 is the umbrella term for the rules that govern the banks' internal capital and liquidity assessments and FI's supervisory review and evaluation process.

The assessments that served as the basis for the requirement in FI's liquidity regulations from 2012 still hold. The Swedish banking system is concentrated, highly interconnected and dependent on well-functioning financing markets. Large amounts are borrowed in EUR and USD, which explains why the separate requirement for the LCR ratio in each of these two currencies is at least 100 per cent. The LCR regulation furthermore prescribes that the currency composition in the liquidity buffer must be in line with the net outflows per currency. Given this background, FI also sees a need for the banks to maintain a good level of contingent liquidity in each of the other significant currencies, including SEK.

As part of Pillar 2, FI requires banks in Supervision Categories 1 and 2, i.e. the largest banks[2], to meet an LCR ratio in both EUR and USD respectively that is at least 100 per cent. FI also intends to apply a Pillar 2 requirement to each individual significant currency, including SEK.[3] The LCR ratio for each of these currencies (excluding EUR and USD) needs to be at least 75 per cent.

The LCR regulation allows a high percentage of covered bonds in the banks' liquidity buffers. At the same time, the regulation contains operational requirements on the diversification of the composition of liquid assets in the liquidity buffers. It is FI's opinion that this diversification requirement means that, when calculating the LCR ratio, there should be a limit on what percentage of the buffers may consist of covered bonds issued by Swedish issuers. The justification for this is that issuers' risk exposure is heavily concentrated to Swedish mortgages, which can affect the bonds' market liquidity if the mortgage market were to suffer shocks. FI takes the position that the percentage of Swedish covered bonds[4] should not exceed 50 per cent of the total liquidity buffer. The diversification requirements set out in the LCR regulations also entail that the banks should ensure that their liquidity buffers are not excessively exposed to any one individual issuer of covered bonds.

It is FI's assessment that the positions it takes in this memorandum will mean that the banks will continue to hold significant liquidity reserves in EUR and USD in relation to outflows in these currencies. At the same time, FI's positions will ensure that the banks are holding sufficiently large liquidity buffers in other significant currencies to meet the regulatory requirements.

[2] Banks and credit institutions are both called "banks" in this memorandum.
[3] A currency is significant if the currency amounts to at least 5 per cent of the bank's total liabilities in accordance with Article 415(2) of the CRR.
[4] Bonds that are issued by Swedish issuers and where the cover pool consists of loans granted against real property, site leasehold rights or tenant-owner rights in Sweden.

FI makes the assessment that its positions on the LCR ratio in individual currencies and the liquidity buffer’s diversification will have a relatively limited impact. Most banks already meet these requirements today, and the others will only need to make minor adjustments.

When it comes to the limitation on the percentage of Swedish covered bonds in the liquidity buffer, it is primarily the banks in Supervision Category 2 that will need to adapt. These adaptations will also be minor, even if the limitation affects more banks than the expanded Pillar 2 requirement for the LCR ratio in individual currencies.

FI intends to apply the expanded Pillar 2 requirement of an LCR ratio of at least 75 per cent in SEK and all other significant currencies (excluding EUR and USD) and the diversification requirement for covered bonds in the liquidity buffers starting with SREP 2019.

Any viewpoints on the positions presented in this memorandum should be submitted to FI no later than 10 April 2019.

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1 Background

1.1 Purpose

Finansinspektionen (FI) accounts in this memorandum for the method it will apply in its supervision of the liquidity coverage ratio (LCR) in individual currencies as part of Pillar 2.[5] This is a part of the annual process during which FI regularly assesses individual banks' risks, i.e. the supervisory review and evaluation process (SREP), that leads to FI's bank-specific requirement on capital and liquidity.

1.2 Background

The financial crisis that broke out in the autumn of 2008 showed that good management of liquidity and financing risks at the banks is key for maintaining stability in the financial system. The lack of resilience demonstrated by the banks[6] to shocks forced the implementation of extraordinary measures from authorities in several countries. The impact of the crisis was extensive, and the costs for society were high. As a result, the regulatory framework for liquidity risks in banks has been reviewed and strengthened over the past few years.

In December 2010, the Basel Committee decided on a new global framework to strengthen banks' capital adequacy and liquidity position.[7] One of the measures was to determine a quantitative minimum requirement on current liquidity coverage, which is called the Liquidity Coverage Ratio (LCR). The aim of this kind of quantitative requirement is to strengthen banks' resilience to current liquidity shocks by ensuring that they hold sufficient high-quality liquidity buffers. According to the LCR requirement, a bank must hold a sufficiently large buffer of liquid assets to be able to withstand future cash flows for a period of 30 days while experiencing heavy liquidity stress.

The LCR requirement is a liquidity stress test that is intended to reflect difficult stresses of items both on and off a bank's balance sheet. The scenarios in the LCR requirement contain a combination of idiosyncratic and market-wide stresses through which the prescribed standardised increments attempt to capture the liquidity effect of, for example,

- the loss of some market financing and some deposits,
- greater outflows from, for example, pledged collateral for derivatives, and

[5] Pillar 2 is the umbrella term for the rules that govern banks' internal capital and liquidity assessments and FI's supervisory review and evaluation process.
[6] In this memorandum, the term *banks* is used for all institutions (banks, credit market companies and securities companies) that are subject to the capital adequacy rules.
[7] Basel III: A global regulatory framework for more resilient banks and banking systems, Basel Committee on Banking Supervision, December 2010, https://www.bis.org/publ/bcbs189.htm

- expanded utilisation of credit and liquidity facilities from customers.

In the stress test for the LCR, the bank may include cash flows during the period, but these are limited by a cap so that only inflows up to a maximum of 75 per cent of the outflows are included. The justification for this is that a bank should have a buffer corresponding to 25 per cent of the outflows even if the bank has perfectly matched it's in- and outflows.

In July 2013, the EU published the Capital Requirements Regulation[8] (CRR) and the Capital Requirements Directive[9] (CRD). The CRR also included binding provisions on liquidity coverage based on the Basel Committee's standard from 2010. The European Commission then received an assignment to prepare a delegated regulation to further specify the requirement. Before the binding minimum standard for the liquidity requirement was fully implemented through the delegated regulation on 1 January 2018, supervisory authorities within the EU could keep or introduce national rules for liquidity risk.

FI took this opportunity to precede the joint regulation at the EU level with national regulations. On 1 January 2013, Finansinspektionen's Regulations (FFFS 2012:6) regarding requirements for liquidity coverage ratios and reporting of liquid assets and cash flows (hereafter FI's liquidity regulations) went into effect. The Swedish liquidity coverage requirement was based on the Basel Committee's standard from 2010 since the liquidity requirement under the CRR was not specified when FI's liquidity regulations were introduced.[10]

In October 2014, the European Commission published the harmonised liquidity coverage requirement in Commission Delegated Regulation (EU) 2015/61 of 10 October 2014 to supplement Regulation (EU) No 575/2013 of the European Parliament and the Council with regard to liquidity coverage requirement for credit institutions (the LCR regulation). This regulation went into effect on 1 October 2015 and entailed a liquidity coverage requirement of 60 per cent on banks; this level has since been gradually raised. The final requirement level of 100 per cent went into effect on 1 January 2018 as a binding minimum requirement throughout the entire EU, repealing FI's national liquidity regulations and

[8] 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.
[9] 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.
[10] At the same time, the Basel Committee published in January 2013 a revised version of its guidelines for calculating the LCR, which changed some of the flow weights in the calculation and allowed the inclusion of more types of liquid assets in the liquidity buffer, assuming that these were accepted by the national supervisory authorities.

Finansinspektionen's regulations (FFFS 2011:37) regarding the reporting of liquidity risks for credit institutions and investment firms.[11]

2 Legal basis

2.1 Additional liquidity requirement in Pillar 2 according to the Supervision Act

The CRD gives national supervisor authorities within the EU the right to decide under Pillar 2 whether a bank should have an additional own funds or liquidity requirement. Pillar 2 is the umbrella term for the rules that govern banks' internal processes for evaluating the need for both capital and liquidity and how FI conducts supervision through the supervisory review and evaluation process (SREP). The provisions regarding additional own funds and liquidity requirements were implemented in Sweden through Chapter 2 of the Credit Institutions and Securities Companies (Special Supervision) Act (2014:968) (the Supervision Act).

FI has had an established, and for the banks well-known, process to establish the banks' capital requirements under Pillar 2 since 2014.[12] The process applied to determine an additional liquidity requirement is the same in all material respects. According to Chapter 2, section 2 of the Supervision Act, FI shall decide on an additional liquidity requirement if necessary to cover the liquidity risks that a bank is or can be exposed to and to prevent the risks the bank poses to the financial system. An additional liquidity requirement is always bank-specific and is preceded by a risk assessment conducted by FI as part of its SREP for the bank.[13]

Just like it does for additional own funds requirements, FI's objective is not to make a decision on an additional liquidity requirement, but rather to inform each individual bank about the result of FI's assessment according to SREP.[14]

2.2 Additional liquidity requirement under Pillar 2 according to the LCR regulation

[11] The CRR states that Member State had the possibility of applying a liquidity coverage requirement of up to 100 per cent for banks in accordance with national legislation until a binding minimum standard of 100 per cent was fully implemented on 1 January 2018. See the decision memorandum (in Swedish) regarding the repeal on FI's website: http://www.fi.se/sv/vara-register/sok-fffs/2017/201719/ orhttp://www.fi.se/sv/vara-register/sok-fffs/2017/201720/.
[12] *Kapitalkrav för svenska banker*, 2014-09-08, FI Ref. 14-6258. A translation is available at www.fi.se.
[13] Chapter 2, section 2 of the Supervision Act implements Article 105 of the CRD that refers to Article 97 of the same directive, which FI, pursuant to section 9 of the Special Supervision and Capital Buffers Ordinance (2014:993), is obligated to apply in its supervision.
[14] In accordance with point 9(2) of *Guidelines for common procedures and methodologies for the supervisory review and evaluation process (SREP)*, EBA/GL/2014/13.

Article 8(6) of the LCR regulation lays down a general requirement that the credit institutions shall ensure that the currency denomination of their liquidity assets is consistent with the currency distribution of their net liquidity outflows. Given this rule, the matching requirement per currency will not be absolute. However, if there is a mismatch in the relationship between the currency denomination of the liquidity buffer and the net outflows in individual currencies, FI can restrict the currency mismatch by setting limits on the proportion of the liquid assets in one currency that a bank can include to cover the liquidity outflows in another currency. This limitation may be applied in either the reporting currency or another significant currency.

If FI chooses to implement such limitations, according to the LCR regulation it should be an additional liquidity requirement under Pillar 2.

2.3 Additional diversification requirement according to the LCR regulation

Article 8(1) of the LCR regulation lays down an operational requirement that the composition of the holdings of the liquid assets that constitute the liquidity buffer shall remain appropriately diversified at all times. This requirement applies to diversification both between the various categories of liquid assets and within the same category of liquid assets, for example between various issuers, counterparties or their geographic locations.

According to Article 8(1), FI may impose specific restrictions on an institution's holdings of liquid assets to ensure that the composition remains appropriately diversified at all times. In FI's view, restrictions on the composition of the liquidity buffer can be considered a specification under current Pillar 1 requirements.

2.4 Overview of FI's considerations and process

FI sees advantages in publicly disclosing in advance the method that serves as a basis for determining additional liquidity requirements under Pillar 2. Even if the result of the SREP, like any eventual decision, is specific to each bank, FI can identify the general points of departure that serve as a basis for the considerations FI intends to include in its supervision. The risks that FI considers when determining the additional liquidity requirement, and that are described in this memorandum, are common for the larger banks.

It is FI's ambition to largely standardise and publish the supervision methods used under Pillar 2 for both capital and liquidity. The purpose of developing methods and a general practice for assessments is to ensure that the banks are treated equally. The Government has also emphasised that a clear and transparent Pillar 2 process, and thus its predictability, is important for both banks and

market participants.[15] FI will also provide information on its website about the general criteria and methods that are applied in the SREP.[16] Given this, it is also FI's ambition to remit and publish the methods that are used to assess liquidity under the Pillar 2 process. In the same manner, FI has previously published memoranda on methods for capital requirements under Pillar 2.

3 Liquidity coverage and diversification

3.1 Pillar 2 requirements for LCR in significant currencies, including reporting currencies

Swedish banks continue to fund a significant portion of their external financing through the money and capital markets in both Sweden and abroad. The banks are dependent on well-functioning financing markets in SEK and foreign currency, primarily in EUR and USD, and are thus exposed to current liquidity risks as a result of potential shocks to the access to liquidity on these markets. Shocks can occur in the market's general functionality, but they can also be the result of failing confidence in a single Swedish bank or the Swedish banking system as a whole. FI takes the position that Swedish banks need to continue to maintain a high level of protection against current liquidity risks. This is important not only for the resilience of individual banks, but in the long run also for the stability in the financial system since the Swedish banks are highly interconnected.

National central banks can provide liquidity support to solvent banks, for example following market shocks, when banks do not have access to financing and/or when the banks cannot convert their liquidity buffers to cash and cash equivalents to cover outflows. However, an expectation of state liquidity support can create problems if, as a result of this expectation, banks take excessive liquidity risks. FI believes that banks' liquidity coverage must be adequate for the banks to be able to handle liquidity shocks on their own, regardless of whether the central bank is expected to provide liquidity support in the currency in question.

[15] Bill 2013/14:228 p. 229.
[16] Section 3 of the Special Supervision and Capital Buffers Ordinance (2014:993).

3.1.1 FI's position

Under Pillar 2, FI requires banks in Supervision Categories 1 and 2[17], to meet an LCR ratio in both EUR and USD, respectively, of at least 100 per cent.

FI also intends to establish a Pillar 2 requirement for each individual other currency, including SEK, provided that the currency is significant for the bank in question. The LCR for these individual currencies (excluding EUR and USD) must amount to at least 75 per cent. The LCR should be calculated in accordance with the LCR regulation.[18]

The Pillar 2 requirement applies to the consolidated situation in affected banks.

FI requires the banks to meet the Pillar 2 requirement every day. However, like for the Pillar 1 requirement for the LCR[19], banks may fall below the requirement during periods of stress to cover unexpected cash outflows.

FI will require a bank that does not meet the Pillar 2 requirement to apply the same principles to restore the level of the requirement as for those applied in the event of a breach of the Pillar 1 requirement.

3.1.2 Reasons for FI's position

In its previous memorandum, *FI:s pelare 2-krav på likviditetstäckningskvot i enskilda valutor* (FI Ref. 17-12809) (in Swedish only), FI formulated a requirement that banks in Supervision Categories 1 and 2 must meet an LCR in EUR and USD, respectively, that amounts to 100 per cent, provided that the currency is a significant currency for the bank. The same memorandum specified that FI may reach the conclusion that it is necessary to apply additional bank-specific liquidity requirements in SEK or other significant currencies.

The considerations and assessments that served as a basis for FI's liquidity regulations are still valid. The major Swedish banks need to maintain a resilience to liquidity risks by having adequate liquidity buffers in different currencies.

[17] See *Finansinspektionens kategorisering av kreditinstitut för den löpande tillsynen och användningen av tillsynsmetoder*, 2018-10-19 FI Ref. 18-15904 (in Swedish only). https://www.fi.se/contentassets/2839e794d0b94614a2adf9e1e51b7714/tillsynskategorisering-svenska-kreditinstitut-2019.pdf.

[18] This means that the calculation for LCR in all significant currencies should be carried out exactly like it is today in accordance with all of the provision of the LCR regulation, including Article 17 on the liquidity buffer's composition and Article 33 of the cap for inflows.

[19] Pursuant to Article 4(3) of the LCR regulation.

FI still considers there to be a value in the banks having the possibility of adapting the composition of their liquidity buffers based on the prevailing market conditions. There is a large supply of liquid assets with the highest credit rating in the large reserve currencies of EUR and USD, and the possibilities to convert these assets to cash are good. Reported data shows that the liquid assets in EUR and USD of the major Swedish banks generally meet a high level of credit quality since they largely consist of government bonds and central bank assets. A larger share of the banks' liquid assets in SEK are covered bonds than is the case for the liquidity reserves in EUR and USD. This is largely due to the fact that covered bonds comprise a very large portion of the outstanding volume of Swedish bonds with low credit risk and good market liquidity.

FI takes the position that a high percentage of liquid assets in EUR and USD in the banks' total liquidity buffer is positive for the banks' overall level of contingent liquidity. If a bank has liquid assets in EUR or USD that exceed the bank's net liquidity outflows in these currencies, the surplus amount can be sold, if necessary. The excess liquidity can then be exchanged to meet commitments in other currencies. Liquid assets in these currencies can thus be used to cover outflows in other currencies, for example SEK, DKK or NOK, if necessary.

At the same time, under the general matching requirements in the LCR regulation, the size of banks' liquidity shortfalls in individual currencies is restricted even if there is a surplus in another currency that easily covers the deficit. The reasoning for this is the desire to avoid an individual bank becoming too dependent on always being able to quickly convert assets to cash to cover a shortfall in another currency.

It is FI's interpretation of Article 8(6) of the LCR regulation that there may not be a major imbalance between the liquidity buffer's distribution of currency and the net cash outflows per currency. FI has previously described the reasoning behind the decision to implement an LCR ratio requirement of 100 per cent in EUR and USD, where the major Swedish banks have a large amount of market funding. For other significant currencies and SEK, FI makes the assessment that the matching must be adequate but not absolute.

Other significant foreign currencies do not have the same importance for the Swedish banks and thus do not have an equally large impact on resilience and financial stability the banks would have given major currency imbalances in EUR and USD.

When it comes to SEK, the question of access to qualifying assets[20] that may be included in the liquidity buffer is important when determining an appropriate level of the LCR requirement. Even though the Riksbank's purchase of government bonds has reduced the volume of government bonds in SEK that are available in the market, FI makes the assessment that there are sufficient

[20] Attributable to the level set out in Article 10 of the LCR regulation.

qualifying assets to meet a requirement of an LCR of 75 per cent without undesirable side-effects.

Given the above circumstances, FI intends to set a requirement of the LCR of 75 per cent for significant currencies other than EUR and USD, which are subject to a requirement of 100 per cent.

3.2 Additional diversification according to the LCR regulation

FI announced in its memorandum *FI:s pelare 2-krav på likviditetstäckningskvot i enskilda valutor* (FI Ref. 17-12809) (in Swedish only) that was published on 19 April 2018 that it would conduct an analysis of the impact of the implementation of the LCR requirement on the banks' liquidity buffers. Potential concentration risks as a result of the banks' cross-ownership of covered bonds are part of this analysis.

FI would like to describe some observations from this analysis and clarify its view on what constitutes appropriate diversification in the composition of the banks' liquidity buffers.

In the data reported by the banks, FI noted a higher percentage of covered bonds (more than 60 per cent) in some banks' liquidity buffers, particularly with regard to Supervision Category 2 banks. These holdings consist of more or less covered bonds issued by Swedish issuers. FI was also able to observe from the data that there are some concentrations at the issuer level in the holdings of covered bonds in the banks' liquidity buffers. . There were also some cases of cross-ownership, i.e. a bank owns bonds issued by another bank, which in turn owns bonds issued by the first bank.

3.2.1 FI's position

FI will restrict the percentage of covered bonds issued by Swedish issuers that may be included in the liquidity buffer. A maximum of 50 per cent of the total liquidity buffer may consist of covered bonds issued by Swedish issuers when calculating the LCR. This restriction applies to the consolidated situation in affected banks.

This restriction further specifies the operational requirement set out in Article 8(1) of the LCR regulation. The Pillar 1 requirement for the composition of the liquidity buffer in different asset categories in accordance with Article 17 of the LCR regulation still applies.

3.2.2 Reasons for FI's position

Article 8(1) of the LCR regulation lays down operational requirements that the composition of the holdings of liquid assets that constitute the liquidity buffer must remain appropriately diversified at all times. This requirement applies to diversification both between the various categories of liquid assets and within the same category of liquid assets, for example between various issuers, counterparties or their geographic locations.

The LCR allows banks to hold more covered bonds in their liquidity buffers than what was allowed previously under national regulations and the Basel standard. This percentage may also consist to some extent of covered bonds with a slightly lower credit quality than what was previously allowed.

Both FI's liquidity regulations and the Basel Committee's global framework for LCR limited the percentage of the liquidity buffer that could consist of covered bonds (40 per cent). The EU's LCR regulation allows for 70 per cent of the liquidity buffer to consist of covered bonds.[21] At the same time, Article 8(1) of the LCR regulation contains an operational requirement on diversification of the composition of the liquidity buffer. This restricts the concentration of the holdings of assets in the liquidity buffer. This is important for Swedish banks given their high share of holdings of covered bonds in SEK by Swedish issuers in their liquidity buffers.

Swedish covered bonds currently have – and have had for a long time – low credit risk, which in part is expressed by the stable high credit rating from rating institutions. These bonds are bought and held by a wide spectrum of investors both in Sweden and abroad. The secondary market for Swedish covered bonds has proven itself to work well under different market conditions.
If one or more banks would need to draw upon their liquidity buffer, and there are no obvious shocks to the mortgage market or the market for covered bonds, it should not be problematic to liquidate Swedish covered bonds by selling or pledging them.

These factors together indicate that Swedish covered bonds should be able to constitute a relatively large percentage of the banks' liquidity buffers.

The largest Swedish banks (Supervision Categories 1 and 2) are also closely interconnected and in general have business models that to a large extent utilise market funding. In a crisis, this market structure could lead to contagion risks, which in turn could give rise to shocks to the financial system as a whole. This systemic risk is amplified by Swedish banks' relatively high ownership of covered bonds issued by other Swedish banks. In addition, there are only around

[21] If covered bonds constitute at the same time at least 20 per cent of the assets according to Level 1, see the calculation rules for the composition of the liquidity buffer in accordance with Article 17 of the LCR regulation.

ten institutions that issue Swedish covered bonds. This means that holders of Swedish covered bonds may be exposed to concentration risk since all issuers have a business focus that is reliant on mortgages.

The asset pool that provides the collateral for covered bonds is heavily concentrated on specifically Swedish mortgages. Even if the credit risk in the covered bonds is low, it is impossible to ignore the risk that investors' demand for bonds could decline sharply if fears were to arise regarding the quality and value of the collateral. One trigger could be concerns about, or the occurrence of, a sharp fall in Swedish house prices. The risk in covered bonds that is associated with the quality of the collateral is particularly relevant in Sweden due to the vulnerabilities FI identified in the form of high household debt and an elevated risk of a fall in house prices.

If house prices were to undergo a correction, prices of Swedish covered bonds could fall. This would reduce the value of the holdings in covered bonds that banks have in their liquidity buffers. In such a situation, it is not possible to rule out that the rating institutions might lower the credit rating of the bonds, which would further reduce interest from investors, impairing the bonds' market liquidity and applying downward pressure on bond prices. If, given such a course of events, banks would need to liquidate some of their holdings of covered bonds, in a worst-case scenario this could prove to be costly if the banks are forced to sell their bonds at an even more reduced price to even attract any buyers.

This reasoning makes it clear that there may be credit and market risks associated with Swedish covered bonds, and in FI's opinion this should mean that banks' liquidity buffers should not be exposed to an excessive extent to Swedish covered bonds as an asset category.

The Pillar 1 requirement for the composition of the liquidity buffer in respect of different asset categories in accordance with Article 17 of the LCR regulation still applies. FI currently sees no cause to limit the total percentage of covered bonds that are allowed in the liquidity buffers of Swedish banks more than what is already specified as Pillar 1 requirements in the LCR regulation.

However, given the discussion above, FI would like to clarify that it takes the position that the liquidity buffer's composition should be diversified so the percentage of covered bonds issued by Swedish issuers amounts as a maximum to 50 per cent of the total liquidity buffer.

FI would also like to clarify that it interprets the operational requirement set out in the LCR regulations such that banks should ensure that their liquidity buffers are not excessively exposed to any one individual issuer of covered bonds. FI will also focus on this point in its ongoing supervision and may place more detailed requirements on diversification at the issuer level as well.

4 Impact analysis

4.1 Impact on banks and competition in the market

Affected banks
There are currently thirteen banks that belong to Supervision Categories 1 and 2. All of these banks already report their liquidity coverage in significant currencies to FI as part of the reporting requirements in the CRR. An LCR requirement for all currencies combined and for EUR and USD individually is already in place for affected banks.

Under the current proposal to expand FI's Pillar 2 requirement, all thirteen banks will be subject to a quantitative liquidity coverage requirement in SEK and other significant currencies (excluding EUR and USD).

The new quantitative requirement of 75 per cent for SEK will not affect the five banks that today only have SEK as their significant currency. These banks already need to hold LCR of 100 per cent for SEK since this has been necessary to fulfil the requirement of 100 per cent in total.

When it comes to other significant currencies, eight of the thirteen banks that belong to Supervision Categories 1 and 2 have EUR and/or USD as significant currency. Two of the banks have GBP as a significant currency, one bank has NOK and DKK, and one bank has JPY.

FI noted in the reported data that the LCR in EUR, USD and other foreign currencies for the thirteen affected banks continues to exceed 100 per cent by a good margin. The LCR in SEK on average is at a relatively high level (above 75 per cent), but at times the fluctuations are large for individual banks. For some banks, the LCR in SEK has been at relatively low levels for long periods of time. The reported data from February 2019 shows, however, that all thirteen institutions in Categories 1 and 2 have an LCR that exceeds 75 per cent in SEK.

Most banks in Supervision Categories 1 and 2 currently meet the new limitation, that the percentage of covered bonds issued by Swedish issuers should not exceed 50 per cent of the liquidity buffer. A few banks in Supervision Category 2 have holdings that exceed 50 per cent of the liquidity buffer. The percentage that exceed the limitation may not be included in the calculation of the LCR. Banks that are able may choose to only include Swedish covered bonds up to the allowed percentage in their calculation. This makes the reported LCR lower. As an alternative, banks may reallocate their holdings to meet the limitation requirement by selling and reducing the percentage of Swedish covered bonds or increasing the total liquidity buffer. The surplus holdings correspond to a reallocation of Swedish covered bonds amounting to a few billion Swedish kronor.

Competition on the market
All European banks are subject to the LCR regulation and thus need to comply with the general currency requirement in accordance with Article 8(6), on which FI's Pillar 2 requirement for LCR in individual currencies is based. All banks are also subject to the operational requirement on diversification in Article 8(1). FI therefore makes the assessment that the impact on competition in Europe should be minimal. FI's requirement could potentially weaken the competitiveness of Swedish banks to a small extent in respect to their international counterparts that are not subject to the LCR regulation. However, FI makes the assessment that a higher degree of protection and resilience to unforeseen disruptions can also have a positive impact on competitiveness by contributing to a high degree of confidence in Swedish banks.

FI takes a fundamentally positive stance to the position that the regulatory conditions for Swedish banks should be the equivalent of those that apply to banks in other EU Member States, but considers there to be justification in some cases to supplement the regulatory framework with additional national measures. The same opportunity is also available to other EU Member States. Norway, Denmark and the UK are examples of some other countries that have LCR Pillar 2 requirements in accordance with the LCR regulation.[22] Some of these countries also have a requirement in the domestic currency.

Given its assessment of the vulnerabilities for the Swedish banking system, FI considers it to be important to ensure that Swedish banks have good resilience to short-term liquidity risks. Since the additional requirements strengthen the resilience of individual banks to liquidity problems, the impact on the confidence in the affected individual banks and the banking system as a whole should be positive.

4.2 Impact on society and the banks' customers

The expanded liquidity requirement presented in this memorandum may change the costs of Swedish banks for their liquidity buffer due to the need to hold a certain minimum level of assets in SEK and the reallocations of liquid assets that may be required to meet the operational requirement on diversification. Because the new requirements do not entail a significant change to the current portfolio structure of the banks subject to the LCR regulation, it should be possible to assume that the additional impact of the quantitative requirements on liquidity coverage in the form of liquid assets is limited.

[22] See Pillar 2 Liquidity CP13/17, 13 July 2017, Bank of England https://www.bankofengland.co.uk/prudential-regulation/publication/2016/pillar-2-liquidity and Afgørelse om yderligere likviditetskrav for danske SIFI'er, 21 juni 2016, Finanstilsynet https://www.finanstilsynet.dk/da/Tilsyn/Tilsynsreaktioner/Afgoerelser/Afgoerelser-2016/SIFI-2016.

FI makes the assessment that consumers, firms and society at large could be positively affected by the new requirements since they aim to reduce the risk of problems in the financial system. Even if the liquidity requirements are based on the risks to which an individual bank may be exposed, liquidity problem in one bank can quickly spread to other banks and in a worst-case scenario turn into solvency problems if liquidity shocks cause losses by triggering events that lead to falling asset values. Ultimately, this is why a bank's liquidity risks are not just a risk posed to the individual bank, but rather to the financial system as a whole. FI therefore makes the assessment that these additional requirements strengthen financial stability.

5 FI's coming supervision work

FI focuses in this memorandum on how the authority intends to place Pillar 2 requirements on liquidity coverage in significant currencies and SEK and on how the authority views the operational requirement on diversification in the LCR requirement with regard to the composition of the liquidity buffer. It should be emphasised that supervision of the banks' liquidity and financing risks include more areas than those covered by the position in this memorandum.

The overall SREP assessments of the banks' liquidity take into account not only LCR in all significant currencies but also LCR under additional stress, the bank's liquidity-related survival horizon under various stress assumptions and the counterbalance capacity and financing profile. FI also review the bank's internal processes for liquidity assessment and policies, processes and procedures to measure and manage liquidity and financing risks.

Another area in focus is the assessment of structural liquidity risks. A general description of this area follows.

5.1 Structural liquidity risks

Structural liquidity risks arise in the banking sector since banks normally utilise maturity transformation. This means that banks' assets usually have a longer maturity than the bank's liabilities. A special standard for measuring structural liquidity risk developed by the Basel Committee is the Net Stable Funding Ratio (NSFR), which places a bank's access to stable financing in relation to the need for financing that arises from the bank's illiquid assets. The aim is to limit the structural liquidity risks that are a direct result of banks' maturity transformation. There is a proposal to introduce this requirement as a binding minimum requirement in the EU.[23]

[23] See Proposal for a REGULATION OF THE EUROPEAN PARLIAMENT AND OF THE COUNCIL amending Regulation (EU) No 575/2013 as regards the leverage ratio, the net stable

As part of its ongoing supervision, FI assesses the banks' liquidity risks in the medium and long term. To be able to conduct its assessment, FI requests data to enable a maturity mismatch analysis of the entire economic life of the banks' assets and liabilities by currency and company. The reported data describes the stability of the bank's financing in a number of pre-defined intervals of time. Since Q1 2018, this data is part of the common reporting framework (COREP) for aggregate capital adequacy. Based on the reported data, FI is working to develop a new supervisory tool to analyse the banks' financing and the balance sheet's structure. This tool can also be used to assess the outcome of stress in terms of different degrees of financial stress and measures across different horizons.

5.2 Concluding remarks

Currently, most of the large banks in Sweden are well capitalised. Profitability is often higher than for similar banks in other parts of Europe. This helps them maintain good access to funding from international investors. However, the financial markets are undergoing structural changes, for example through the emergence of new products and market participants, which can lead to new risks. In order for resilience in the system – in the form of both liquidity and capital – to continue to be satisfactory, FI believes that the regulation and supervision of liquidity risks needs to take into account and counteract the vulnerabilities present in the Swedish banking market. Good resilience to shocks to the financial system strengthen confidence in the entire banking sector. FI's assignment to conduct risk-based supervision therefore entails being proactive and carefully following market developments and any structural changes to ensure that FI's internal methods for assessing banks' liquidity and financing risks in both the short term and the long term remain relevant.

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funding ratio, requirements for own funds and eligible liabilities, counterparty credit risk, market risk, exposures to central counterparties, exposures to collective investment undertakings, large exposures, reporting and disclosure requirements and amending Regulation (EU) No 648/2012, https://data.consilium.europa.eu/doc/document/ST-6288-2019-INIT/en/pdf?utm_source=dsms-auto&utm_medium=email&utm_campaign=Banking+Union%3a+EU+ambassadors+endorse+full+package+of+risk+reduction+measures.