



FI Ref. 15-468

Finansinspektionen
Box 7821
SE-103 97 Stockholm
[Brunnsgatan 3]
Tel +46 8 787 80 00
Fax +46 8 24 13 35
finansinspektionen@fi.se
www.fi.se

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

Summary

Finansinspektionen proposes that a waiver be introduced from the requirements in Article 129(1)(c) of the Capital Requirements Regulation¹ 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 proposes that this waiver possibility be introduced. 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 amendment to the regulation is proposed to enter 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.

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1 Introduction

1.1 Objective of the regulation

The objective of waiving 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 amending Regulation (EU) No 648/2012 (the Capital Requirements Regulation) now being proposed 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 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 Article 129(1) (c).

Article 129(1) (c) sets out that 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 requirements for preferential treatment, it is the credit rating of the issuer that determines the risk weight, this being 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, 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 2⁴ 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 national law⁵ 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

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) are otherwise considered capable of causing substantial concentration problems in Denmark, and according to the EBA the consequences thereof include a deterioration in the competitive landscape of 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.

1.2.3 Swedish regulation of covered bonds

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

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 Finansinspektionen's regulations and 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.

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 decided to approve this in the individual case. 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 as of 1 January 2015. Hence, exposures to credit institutions that collateralise covered bonds shall meet the requirements set out in Article 129(1) (c) if such bonds shall continue to 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 implemented by decisions in each individual case.

Furthermore, Finansinspektionen considers that a waiver of that which follows from the Capital Requirements Regulation, which is directly applicable in Sweden, cannot be introduced through general guidelines.

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.

Because Finansinspektionen is authorised to introduce the waiver through regulations (read more about this below), the proposal is that the waiver be introduced in Finansinspektionen's regulations (FFFS 2014:12) 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 introducing such a waiver 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 for credit quality step 1 referred to 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 (i) the calculation of the own funds requirement and own funds and (ii) 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 (i) the own funds requirement and own funds and (ii) 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 will, in the work on a regulatory proposal, consult with EBA regarding introducing the waiver. The EBA will, on its website, publish an opinion on Finansinspektionen's intention to introduce the waiver.

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 what applied under the transition rule in the Capital Requirements Regulation that applied through 31 December 2014, no external reference

group has been appointed. However, in 2014 Finansinspektionen was in regular contact with the Swedish Bankers' Association regarding a perceivable introduction of the waiver and intends to continue this informal consultation in the process as it continues.

The consulted bodies that are, in Finansinspektionen's opinion, the most affected by the proposal have been informed that the consultation period will be briefer than what normally applies in accordance with Finansinspektionen's regulatory procedure.

The amendment to the regulation is proposed to enter into force on 31 March 2015.

2 Motivation and considerations

2.1.1 Covered bonds

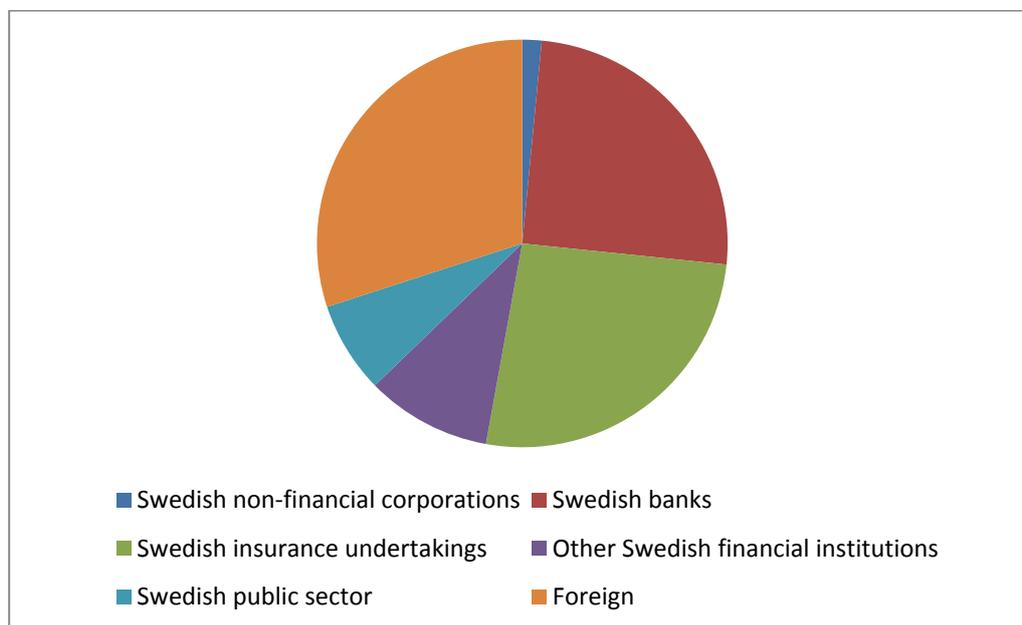
Covered bonds are interest-bearing securities which, following authorisation from Finansinspektionen, are issued by banks or credit market companies. The holders of the bonds have a special right of priority to a cover pool if the issuer is subject to foreclosure or enters into bankruptcy.

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 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.⁸ For these credit institutions, covered bonds are an important source of funding.

Diagram 1 below illustrates the breakdown of ownership of Swedish covered bonds between different categories of owners. 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.

⁸ Stadshypotek and SCBC are the mortgage institutions of, respectively, Svenska Handelsbankens and SBAB.

Diagram 1 – Breakdown of ownership of Swedish covered bonds, second quarter 2014 (source: Statistics Sweden)



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, supplementary assets are also 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.

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 proposing the regulatory amendment.

The issuers use derivatives to strike a sound 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 the extent to which 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 mitigated by means of the issuer of the bond entering fixed income derivatives.

Issuers of covered bonds also issue bonds in a currency⁹ 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.¹⁰ Because mortgages for homes denominated in Swedish kronor are often included in the cover pool for Swedish covered bonds issued in foreign currencies, a foreign exchange risk arises, which issuers manage by entering foreign exchange derivatives.

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.

As shown in the table, only 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*

⁹ Primarily euro.

¹⁰ http://www.ascb.se/Pages/4_Marketinformation.aspx

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, if the waiver is introduced, this would involve 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 probability of losing money on holdings in such covered bonds. Finansinspektionen intends to regularly evaluate whether potential concentration problems still 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.

2.1.5 Overall assessment

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

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 attributable to derivative exposures that lead to Finansinspektionen's wish to introduce the waiver. Because it is unclear whether it is permitted, under the Capital Requirements Regulation, to limit the waiver to derivative exposures alone, Finansinspektionen proposes that the waiver shall apply 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. For example, an issuer may not use bonds issued by credit institutions as supplementary cover assets unless Finansinspektionen, following application, has decided to approve this in the individual case.

2.2 Scope

The prudential requirement regulations encompass banking companies, savings banks, members' banks, credit market companies and credit market associations, and investment firms. The provisions also encompass 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 and consumers, as well as for Finansinspektionen.

The proposal involves the requirements for exposures to credit institutions that collateralise covered bonds that are eligible for preferential treatment being 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 is not put in place, concentration problems may arise because issuers of Swedish covered bonds 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 as to which Swedish credit institutions may act as derivative counterparties for issuers of covered bonds compared to the transition rule that applied previously. Hence, the amendment to the regulation does not involve any practical difference in the application of the requirement in Sweden.

3.1 Consequences for institutions

Those affected by the proposed regulatory amendment are the firms encompassed by the scope of the prudential requirement regulations 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.

The introduction of the regulatory amendment is not considered to involve any substantial administrative expenses, either for investors or for issuers of covered bonds. The regulatory amendment will not involve the firms having to adapt their operations. Small firms are not expected to be notably affected, and no specific consideration has therefore been given to them in the work on the regulations.

For the issuers, the regulatory amendment is not considered to involve 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.

The regulatory change is not considered to trigger any financial expenses for credit institutions with holdings in Swedish covered bonds. However, a scenario in which the proposed regulation is not introduced would make it harder for the covered bonds to meet the requirements for preferential treatment in terms of capital adequacy. This 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. FI judges that the bonds that do not meet the requirements would therefore be more difficult to issue, and that investors would want a higher return for them. This would bring about increased financial expenses for the issuers in the form of more expensive funding.

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 could ultimately affect borrowers.

3.3 Consequences for Finansinspektionen

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