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General approach to assessing Pillar 2 guidance for Swedish banks

Summary

As part of the implementation of the EU's new capital adequacy regulations in Sweden, Finansinspektionen may establish a so-called Pillar 2 guidance for each undertaking (hereafter bank) subject to the Supervision Act. FI must assess a suitable level for each bank's own funds to cover, for example, risks or aspects of risks and manage future stressed situations. This coverage applies in addition to the existing coverage from the minimum requirements, the additional own funds requirements, and the combined buffer requirement, or the requirement on a leverage ratio buffer. If FI finds that a bank needs more capital, we will communicate this to the bank via the Pillar 2 guidance.

In this memorandum, we describe the general approach that FI will apply to assess the banks' Pillar 2 guidances. The approach extends the information published in November 2020 in the memorandum "Nya kapitalkrav för svenska banker".[1]

The preparatory works for the new Supervision Act say that the Pillar 2 guidance can be assessed using both stress tests and other aspects. FI intends to start with a quantitative stress test to assess how much capital each bank should hold. The results from the stress test will then be supplemented with other relevant grounds for assessment before applying an overall assessment to determine the guidance that will be communicated to the bank.

In this memorandum, FI also describes its view on how the bank can use the capital capacity that is created through the guidance.

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

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1 Background and introduction

1.1 Background and purpose

The regulatory framework for the Swedish banks' capital requirements was changed by the EU's banking package for risk mitigation measures (the banking package).[2] The banking package was the result of global negotiations from the cooperation between the Basel Committee for Banking Supervision (the Basel Committee) and the Financial Stability Board (FSB). The banking package changes the EU's capital adequacy regulations primarily by amending the CRR[3] and the CRD.[4] The CRR is directly applicable in all Member States, and the amendments largely go into effect as of 28 June 2021. The amendments to the CRD have been implemented into Swedish law primarily through the Credit Institutions and Securities Companies (Special Supervision) Act (2014:968) (the Supervision Act) and the Capital Buffers Act (2014:966) (the Buffers Act). The amendments entered into force on 29 December 2020.

The general aim of the amendment is to further mitigate the risks in the EU's banking sector by strengthening the banks' resilience to crises and ensuring that critical functions can be maintained during a crisis. FI described in the capital requirement memorandum how we intend to apply the new rules in Sweden.

As part of the implementation of the new rules, FI has chosen to call the guidance in Pillar 2 for the *Pillar 2 guidance*. The aim of the Pillar 2 guidance is for each bank to have sufficient own funds to cover risks or aspects of risks that are not covered by other requirements and be able to absorb losses during a financial shock. This creates a threshold before breaches to the various buffer requirements require automatic dividend restrictions. No Swedish bank is subject to a leverage ratio buffer in Pillar 1. For the banks that have a leverage

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[2] Proposals in this memorandum relate to the firms that are subject to the Supervision Act. This comprises credit institutions, including banks, and some securities companies, at both the individual level and the consolidated level. In this memorandum, all of these firms are referred to as *banks*. However, as of June 2021, most securities companies will instead be subject to a special capital adequacy regulatory framework for securities companies; see Bill 2020/21:173. Therefore, they will not be impacted to any major extent by this memorandum.

[3] Regulation (EU) No 575/2013 of the European Parliament and of the Council on prudential requirements for credit institutions and investment firms is called the Capital Requirements Regulation (CRR). The amendments in the banking package were implemented through Regulation (EU) 2019/876 of the European Parliament and of the Council amending Regulation (EU) No 575/2013 and Regulation (EU) No 648/2012. This amendment regulation has since then been amended to some extent by Regulation (EU) 2020/873 of the European Parliament and of the Council as regards certain adjustments in response to the COVID-19 pandemic.

[4] Directive 2013/36/EU of the European Parliament and of the Council on access to the activity of credit institutions and the prudential supervision of credit institutions and investment firms are called. The amendments in the banking package were implemented through Directive (EU) 2019/878 of the Parliament and of the Council amending Directive 2013/36/ EU.

ratio requirement as their most restrictive requirement, the guidance constitutes a buffer to prevent breaching the minimum requirement.

The capital specified in a Pillar 2 guidance can be calculated using stress tests as well as other aspects. This memorandum presents a general plan for how FI intends to assess the capital that will be specified in a Pillar 2 guidance with an emphasis on the portion provided by stress tests. If needed, FI will communicate at a future point in time more details on how the other aspects are to be assessed than those provided in this memorandum. If FI intends to add new steps to the approach or change an existing step in such a way that the outcome will be materially impacted, and if it is relevant for several banks, FI will submit such supplements for separate consultation.

1.2 FI's previous communication regarding Pillar 2 guidance

According to the new rules for the Pillar 2 guidance, FI must communicate to affected banks what is considered a suitable level for each bank's own funds to cover, for example, risks or aspects of risks and manage future stressed situations. This coverage applies in addition to the existing coverage from the minimum requirements, the additional own funds requirements, and the combined buffer requirement, or the requirement on a leverage ratio buffer.

The Pillar 2 guidance replaces the capital planning buffer that FI has applied previously. The following summarises the announcements made previously regarding the design of the Pillar 2 guidance.

FI intends to use stress tests as a starting point to assess the size of the Pillar 2 guidance. Other components may be included in the guidance.

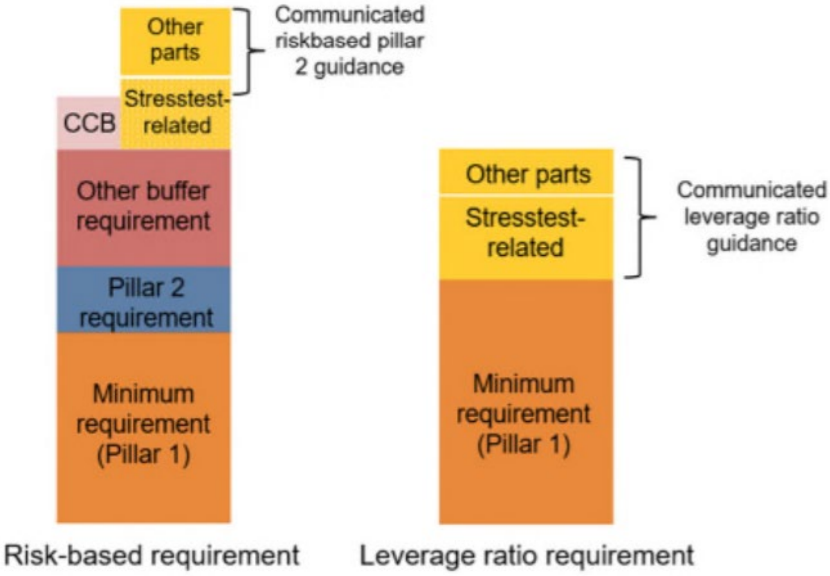
FI will assess for each bank:

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

The capital needs that are determined through the capital conservation buffer should be deducted from the risk-based Pillar 2 guidance. This means that the risk-based Pillar 2 guidance communicated to the bank will specify the level that exceeds the capital conservation buffer. A corresponding deduction is not made for the leverage ratio guidance since there is no equivalent of the capital conservation buffer in the leverage ratio rules.

Diagram 1 provides a schematic presentation of how the guidance relates to the other components of the capital requirement.

Diagram 1 General design of the guidances



Source: FI
Note: CCB stands for capital conservation buffer. The size of the different components in the diagram and the bars' relationship to one another should not viewed as an indication of how the provisions will actually be applied.

FI will communicate to the bank both a risk-based guidance and a leverage ratio guidance for the highest organisational level over which we exercise supervision. This means that we will communicate to the bank the guidance at the group level (consolidated situation) if there is a group under Swedish supervision; otherwise we will communicate the guidance at the individual level. Under special circumstances, FI may communicate a guidance at the individual level even if the group is under Swedish supervision.

The risk-based Pillar 2 guidance and the leverage ratio guidance will only be able to be met using common equity Tier 1 capital. Since FI in general will decide and express the additional own fund requirement as a percentage of the total risk-weighted assets or the leverage ratio exposure amount, we will also specify the guidance in the same way. FI will also publish communicated guidances.

If a bank violates the guidance, there are no automatic consequences. However, the law stipulates that FI has the option of taking measures if a bank does not maintain sufficient own funds to meet the guidance communicated to the bank. For example, FI can intensify its follow-up of supervision measures at the bank or decide on a Pillar 2 requirement. In simple terms, we can fully or in part replace the guidance with an additional own funds requirement. This, in turn, can lead to the bank being subject to automatic restrictions on some value transfers, for example, if the bank does not meet the combined buffer requirement.

In terms of the size of the Pillar 2 guidance, FI makes the assessment that the guidance for most banks will amount to 1.0–1.5 per cent of their risk-weighted assets and 0.2–0.5 per cent of the leverage ratio exposure amount. These figures may vary between banks, and individual cases may be lower or higher than the stated intervals.

The guidance FI communicates to a bank will apply until we communicate a new guidance.

1.3 Scope

For all banks subject to the Supervision Act, where provisions regarding the Pillar 2 guidance have been inserted, FI must assess what constitutes a suitable level of total own funds for each bank and based on this figure communicate to the bank a Pillar 2 guidance, where relevant. Therefore, all of these banks may be subject to such guidance.

FI conducts annually a supervision categorisation in accordance with the European Banking Authority's (EBA) guidelines (EBA guideline) on the supervisory review and evaluation process (SREP).[5] The categorisation includes Swedish credit institutions and foreign credit institutions' Swedish branches and is done in part to show how FI applies proportionality in its supervision. The supervision categorisation is adopted in the autumn every year and published on FI's website.[6]

One of the aims of the categorisation is to provide FI with a basis on which to decide the frequency and scope of each bank's SREP. FI will make its assessment of a relevant Pillar 2 guidance as part of the SREP.

Generally, FI will review the assessment

- annually for banks in Supervision Category 1
- every second year for banks in Supervision Category 2.

FI may deviate from this timetable if there are grounds to do so. For banks in Supervision Categories 3 and 4, however, the SREP is conducted less

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[5] Revised guidelines for common procedures and methodologies for the supervisory review and evaluation process (SREP) and supervisory stress testing and amending EBA/GL/2014/13 of 19 December 2014.

[6] For more information about FI's categorisation method, see the memorandum "Finansinspektionens kategorisering av kreditinstitut och filialer för den löpande tillsynen och användningen av tillsynsmetoder" (FI Ref. 19-18524), September 2019, FI. Available in Swedish. For more information about the current categorisation, see the memorandum "Tillsynskategorisering av svenska kreditinstitut och utländska kreditinstituts svenska filialer för 2021" (FI Ref. 20-1930), September 2020, FI. Available in Swedish.

frequently, insofar there is no indication of material risks to financial robustness or deficient compliance with regulations.

The legislation that regulates the Pillar 2 guidance entered into force primarily on 29 December 2020. The rules on the leverage ratio enter into force on 28 June 2021. In terms of the timing of the first communication of a suitable Pillar 2 guidance, FI will make its assessment of the risk-based guidance and the leverage ratio guidance in conjunction with the first SREP that the bank is subject to after the respective changes to the Supervision Act have entered into force.[7]

1.4 Legal basis

The possibility for FI to decide on suitable levels of own funds and based on this communicate to the banks their respective Pillar 2 guidance is set out in Chapter 2, section 1c of the Supervision Act. The preparatory works for the provision state that the guidance may be determined on the basis of a stress test as well as other considerations.[8] In other words, the guidance is determined by the capital judged to be necessary given the stress tests, but also capital judged to be necessary on the basis of other aspects.

According to the same preparatory works, the guidance may cover risks that are subject to decisions on additional own funds requirements only to the extent the guidance covers aspects of these risks that are not already covered by the additional own funds requirement. In other words, the guidance may be used to cover the same risks that are already covered by the additional capital requirement, but it needs to target other aspects of these risks.

According to the same preparatory works, the guidance should be institution-specific. In the same way as for the additional capital requirement, FI can use different assessment methods to determine the size of the guidance. The methods generate an institution-specific result since they consider each bank's individual exposures.

There is also no provision in the regulations that prevents the use of a simplified stress test for certain categories of banks. Point 388 of the EBA's guideline also specifies that simplified stress tests can be used.

1.5 Preparation of the matter

In the consultation memorandum on FI's application of the new capital requirements for Swedish banks that was published on 25 September 2020, FI

[7] For more information, refer to the memorandum "Tillämpning av kapitalkrav tills FI:s nästa beslut om särskilda kapitalbaskrav efter en översyn och utvärdering" (FI Ref. 20-28013), December 2020, FI. Available in Swedish.

[8] Bill 2020/21:36, page 113.

announced its intention to develop an approach to assess the Pillar 2 guidance and submit a proposal in the spring of 2021.

On 1 December 2020, FI arranged an informational meeting for industry representatives and presented its general plan for designing the approach. At the meeting, we presented, for example, our intention to start with various stress tests, divide the banks' outcome into different intervals and qualitatively assess the outcomes.

On 15 February 2021, FI submitted a proposal for a general approach to assess the size of the Pillar 2 guidance for Swedish banks (the consultation memorandum).[9] The proposal was sent to thirteen consultation bodies and also published on FI's website. The final date for responses was 12 March 2021. The following organisations submitted responses: *Association of Swedish Finance Houses*, *Swedish Investment Fund Association*, *Kommuninvest i Sverige AB (Kommuninvest)*, *Swedish Competition Authority*, *Swedish National Debt Office (SNDO)*, *Swedish Savings Banks Association*, *Swedish Bankers' Association*, *Sveriges Riksbank (the Riksbank)* and *Swedish Fintech Association*. Swedish Investment Fund Association, Swedish Competition Authority, and SNDO had no comments on the proposals in the consultation memorandum.

FI has considered all submitted consultation responses, including those that we do not present in the memorandum. With regard to the feedback that we should clarify how we intend to apply the approach, we have to the greatest extent possible responded by directly adjusting the text.

2 General approach

This section presents the approach that FI will use to assess both the risk-based and the leverage ratio-based Pillar 2 guidances at a general level.

The approach is based on a two-step process. The first step is a stress test that, using a number of assumptions and methodology choices, estimates how much the bank's common equity Tier 1 capital ratio could fall. The outcome from the stress test will be rounded off into buckets. In the second step, FI then takes other quantitative and qualitative aspects into consideration.

FI will conduct an overall assessment of the two steps to determine for each bank the percentage of additional capital that is suitable for the bank to be able to manage the risks or aspects of risks that were identified during the assessment and have not already been covered by the other parts of the capital

[9] See the consultation memorandum "Övergripande ansats för att bedöma pelare 2-vägledningen för svenska banker" (FI Ref. 20-28036), FI, 15 February 2021.

requirement. Through an overall assessment, FI can also ensure that there are no major unmotivated changes in the outcome from one year to the next.

FI will communicate to the banks the guidance it finds suitable based on the approach, although the capital conservation buffer will be deducted from the risk-based guidance.

2.1 General feedback from the consultation responses

2.1.1 Feedback received

The Swedish Bankers' Association is of the opinion that the proposed approach is not clear enough. The sensitivity-based stress test method that is presented is not sufficiently specified for individual banks to be able to estimate the impact on them. The same applies to the grounds for the qualitative assessment. The Swedish Bankers' Association also does not consider it to be clear how the different grounds for assessment will be applied together. The consultation body asserts that it will be difficult for the banks to predict the outcome of the approach, which in turn presents a challenge in their internal capital planning. In terms of the frequency with which the Pillar 2 guidance will be determined, the Swedish Bankers' Association agrees with FI that it should be conducted in conjunction with each bank's SREP. For the banks that have not had a capital planning buffer previously, the Swedish Bankers' Association takes the position that these banks should be able to continue in the same way until they have been communicated their first Pillar 2 guidance. The Swedish Bankers' Association also emphasises that any double-accounting against other capital requirements should be avoided. Finally, the Swedish Bankers' Association in this part takes the position that FI, when determining the guidance, must consider relevant conditions for the individual bank and that it is not sufficient to adapt only to the supervision category to meet the statutory requirement on the guidance's institute-specific nature.

Kommuninvest emphasises that FI should sufficiently consider different types of business models and a stress test approach that is too uniform would not be suitable. Special consideration in this regard should also be given to the qualitative aspects and the overall assessment.

The Riksbank supports the proposed approach. The Riksbank takes the position that the Pillar 2 guidance should cover the structural risks that Swedish banks are exposed to and that the risk-based guidance should not fall below the level of the capital conservation buffer. Furthermore, the Riksbank takes the position that there is a risk that stress tests not based on a macroeconomic scenario will underestimate the covariance between different risk parameters and that the macro-based stress test method should therefore be given a central role in the calculation of the guidance. The Riksbank also takes the position that the guidance should be adopted through a decision.

The Swedish Savings Banks Association initially highlights that the proposal is called *övergripande ansats*/*general approach* and not a *kapitalkravs-pm*/*capital requirement memorandum* or *metod-pm*/*methodology memorandum*. The Association also questions why FI is using the term *pelare 2-vägledning*/*Pillar 2 guidance* instead of one of the terms used in the Supervision Act (*underrättelse om lämplig kapitalbasnivå/notification of suitable own funds level)* or the Capital Requirements Directive (*riktlinje för ytterligare kapitalbas*/*guideline for additional own funds*). Furthermore, the Swedish Savings Banks Association takes the position that the proposal will not provide a sufficiently institution-specific assessment since it is not enough that the calculations are based on the individual banks' exposures. The Swedish Savings Banks Association also gave feedback on the process for how FI assesses a suitable Pillar 2 guidance. First, the Association considers that banks in Categories 3 and 4 should have an SREP determined at more frequent intervals than what has been the case to date. The Association further interprets FI's wording in the consultation memorandum to mean that an SREP may be conducted more infrequently going forward. Individual savings banks may then need to determine their capital needs without a dialogue with FI over a long period of time, which creates a risk that divergent opinions about the scope of the capital need will emerge. The Association also interprets FI's wording to mean that an assessment will not always be conducted and therefore points out that FI, in contrast, is obligated by law to assess the matter for all banks. It also takes the position that the decisions about the Pillar 2 guidance should be justified in the same way as the other capital requirements. Overall in this part, the Association takes the position that it would be suitable for a simplified procedure for the banks in Categories 3 and 4 in order to make it possible to conduct the SREP at more frequent intervals.

The Swedish Fintech Association gives general feedback that the proposal is not sufficiently adapted to smaller actors that are growing quickly and are in an investment phase, are new to the market or have a high capital adequacy to cover an expansion phase. They also assert that FI is not sufficiently transparent in the published method about how these types of companies will be assessed. The proposal is considered to discriminate against market participants in the above-mentioned groups to the benefit of larger and more traditional banks, and the risks in the banks are not considered to be adequately measured. In terms of the process for determining the guidance, the Swedish Fintech Association takes the position that there is a risk that the fact that SREP is carried out more infrequently than every second year for banks in Supervision Categories 3 and 4 could lead to the guidance being misleading and irrelevant, particularly for smaller and fast-growing companies.

The Association of Swedish Finance Houses does not consider the general description in the consultation memorandum to be sufficient to estimate the effect on the individual institution. This applies to the main stress method, the sensitivity-based method and the grounds for the qualitative assessment.

2.1.2 FI's comments on the general feedback from the consultation responses

FI notes that several of the consultation bodies would like us to present the approach, and its components, in more detail than we did in the consultation memorandum. For example, the industry organisations take the position that the approach should be so clearly described that the banks in practice could calculate the outcome themselves. With the goal of further enhancing the affected banks' ability to understand FI's method, each bank, when receiving the verification letter in which FI presents the preliminary guidance, will also receive information about how the sensitivity-based stress test has been calibrated and the outcome it generated. However, FI will also apply a qualitative assessment, which means that the final guidance may deviate from the stress test outcome.

In terms of *the Swedish Bankers' Association's* feedback that it would be improbable for many banks to get an outcome that exceeds the capital conservation buffer's 2.5 per cent since few have had an additional capital requirement above this level with the capital planning buffer, FI would like to highlight the following. Even if the method for the sensitivity-based stress test builds further on the method that has been used until today to calculate the capital planning buffer, there are several differences between them, and they are therefore not completely comparable. Furthermore, consideration is now given to outcomes from different types of stress tests. As mentioned above, additional grounds for qualitative assessment may also be considered.

The issue of double-accounting against other capital requirements, which *the Swedish Bankers' Association* also highlights, is not a new issue; it has also been discussed in conjunction with the capital planning buffer. FI can therefore repeat what it has stated previously in this matter. The Pillar 2 guidance must constitute a first line of defence against falling capital adequacy, i.e., losses and increasing risk-weighted exposures amounts, and the risk of falling below the capital requirement as a result. The assessment of the size of the guidance therefore unavoidably encompasses the same types of risks as Pillar 1 and Pillar 2 do otherwise, for example credit loss risk, but with assumptions that are not as conservative. FI's application is not unique; it is in line with how the regulatory framework is intended to be applied in practice and with how others within the EU, for example the single supervisory mechanism in the banking union, apply it. However, the guidance should not cover risks that otherwise are covered by the combined buffer requirement.

Several of the consultation bodies present general feedback about the frequency of SREP and the Pillar 2 guidance assessment. *The Swedish Savings Banks Association* and *the Swedish Fintech Association* state in their consultation responses that the assessment will be conducted too infrequently for banks in Supervision Categories 3 and 4. The Swedish Savings Banks Association proposes that FI should establish a simplified procedure for these banks in order for it to be possible to conduct the assessment more frequently.

FI notes this feedback. We intend to review if it is possible to conduct the SREP for banks in Supervision Categories 3 and 4 more frequently by simplifying some procedures.

As presented above, several of the consultation bodies take the position that the approach is not sufficiently institution specific. For example, it is asserted that the break-down into supervision category and the calculation based on individual exposures are not sufficient grounds for determining an institution-specific assessment. Furthermore, it is asserted that the approach would be too centric to the situation of the major banks and not designed for smaller, newly established banks. FI would like to point out here that qualitative aspects are included as part of the overall assessment of the size of the guidance for this very reason, i.e., to ensure that a calculation is not applied mechanically without further overview by responsible experts. At the same time, the approach must be based on different common denominators to be predictable and ensure that applicable legislation is applied in accordance with the rule of law.

FI shares *the Riksbank's* opinion that the Pillar 2 guidance should cover the structural risks that Swedish banks are exposed to and takes the position that this is ensured through the total capital requirements, including the guidance. We would like to further emphasise that two macro-based stress test methods, in addition to other grounds, will be considered in the assessment of the guidance for Category 1 banks and some Category 2 banks. In terms of the Riksbank's request that FI make formal decisions regarding the Pillar 2 guidance, it is noted that according to Chapter 2, section 1c of the Supervision Act, the authority shall inform an institution about the difference between suitable own funds levels for the institution and its own funds requirement pursuant to the Capital Requirements Regulation, the Buffers Act and the Supervision Act. This means that the Pillar 2 guidance cannot take any other legal form than a notification. The notification of the Pillar 2 guidance will typically be communicated in the same document as a decision regarding an additional own funds requirement.

In terms of *the Swedish Savings Banks Association's* terminology-related feedback, the reason that FI has chosen to call the proposal *övergripande ansats/general approach* is that it builds further on several underlying methods, and given this background it would be misleading to call it a *method*. In terms of the phrase *pelare 2-vägledning/Pillar 2 guidance*, this is suitable since we consider it to better capture the measure's nature and aim; also, the term *riktlinje/guidance* is typically associated with the guidelines that are issued by the EBA. The term has also already been used in FI's regulations (FFFS 2014:12).

2.2 Main stress test method and allocation into buckets

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

The method estimates how much the banks' common equity Tier 1 capital ratio would fall as a result of the stress, and based on this outcome FI will allocate each bank to a bucket on a scale of rounded-off percentages. The size of the buckets will differ between the risk-based Pillar 2 guidance and the leverage ratio guidance.

2.2.1 Feedback received

The Swedish Bankers' Association takes the position that the sensitivity-based stress test method should be presented in more detail so the banks are able to predict the outcome of the stress test method and allow for the future guidance in their capital planning. The Swedish Bankers' Association does not object to the allocation to buckets as such, but takes the position that FI should use the mid-point of the bucket instead of its max point. The Swedish Bankers' Association also considers the buckets to be too large and asserts that they should instead be at the most 0.25 per cent of risk-weighted assets and 0.075 per cent of the leverage ratio exposure amount. *The Association of Swedish Finance Houses* presents similar feedback.

Kommuninvest asserts with regard to its business model that earnings are not a primary goal, and tests that are modelled based on this parameter can therefore be misleading in comparison with other banks. Kommuninvest also highlights that the firm only lends to counterparties with a risk weight of zero.

The industry organisation *Swedish Fintech Association* highlights that the terminology in FI's proposal is not fully consistent about what is being assessed within the sensitivity-based stress test method: a fall in the absolute capital level or the capital ratio. They are of the opinion that it should be the former. Furthermore, the Association interprets the proposal such that firms with high capitalisation in relation to their total minimum and buffer requirements will not be credited for such margins. With regard to the calibration choices that are described in more detail in the appendix to this memorandum, the Swedish Fintech Association also considers there to be a risk that an assumption of a static balance sheet will generate a distorted view of firms that have high growth and firms with a high turnover rate. The organisation also does not consider historical costs to be a suitable starting point for assessing what costs will be forward-looking, and particularly not for a firm in a growth phase. The Swedish Fintech Association also takes the stance that it is not as clear for banks that do not use IRB models how credit losses will be estimated compared to banks that do.

In terms of the choice of leases as one of the risk parameters that will be included in the sensitivity-based stress test method, *the Association of Swedish*

Finance Houses asserts that the capital requirements for Pillar 1 are already set too high.

2.2.2 Reasons for FI's position

Main stress test method

FI makes the assessment that it is suitable to use a sensitivity-based method as the main stress test method. Therefore, for this purpose we have further developed the method that we to date have used to set the capital planning buffer.[10] The method has been expanded to be able to consider more risks in terms of the larger banks. It has also been adapted to be able to be adapted to smaller banks.

The method is constructed through assumptions of changes to different risk parameters, for example credit losses, net interest income, commission income and net financial income/expense. In other words, it is not based on an underlying macroeconomic scenario. Under this method, an assumption is also made that Category 1 banks will experience a certain growth rate in their balance sheet in the form of replacing past due market financing of existing customers. The stress test method is used to assess which negative changes in available capital could arise, both in terms of risk and leverage ratio. The risk-based calculation also includes changes to the risk-weighted exposure amount.

The calculation is based on the most recently reported income statements and balance sheets, or the most recent previous years, over the course of three years. If FI, for any reason, should make the assessment that the income statement and balance sheet are not representative, for example if they were impacted by major, obvious one-off effects, the outcome may be adjusted for this to better fulfil the stress test's forward-looking objective.

By basing the stress test on the results from the previous year, there is a risk that the model will have some procyclical features. In other words, a weak macroeconomic development that results in credit losses at the banks may mean that they will be assigned higher Pillar 2 guidances. This in turn could lead to a credit crunch, and thereby place additional pressure on the economic activity. FI strives to the greatest extent possible to avoid such procyclical features in regulations and supervision tools. We will therefore follow this carefully and review different ways to manage this effect in the continued development of the method.

The Swedish Fintech Association objects to the calculations being based on historical data and the assumption of a static balance sheet since there is a risk that these will be misleading for newly started or rapidly growing firms. FI understands this viewpoint to some extent but notes that this is an accepted

[10] See the memorandum "Stresstestmetod för bedömning av kapitalplaneringsbuffert"(FI Ref. 15-11526), August 2016, FI. An English translation is available at www.fi.se.

methodological choice when it comes to stress tests. Firms that are growing rapidly are also not only at a disadvantage since the assumption of a static balance sheet, all else equal, should lead to an underestimation of the future need for capital. It is also natural for FI to allow some room for higher costs. With that said, one of the objectives of also considering other grounds of assessment as presented in section 2.3 is to be able to make an institution-specific assessment of, for example, any items that are obviously one-off in nature and therefore should be excluded from the basis. In terms of the feedback that firms with large margins to the minimum and buffer requirements – the so-called management buffer – would not be credited for such margins, we do not consider this to be a relevant objection. FI is to assess what constitutes a suitable total level for a bank's own funds, and if we assess that a guidance above the minimum and buffer requirements is justified, the bank will be communicated a guidance. The level of capital the bank then chooses to hold in addition to this total level is a matter for the bank itself.

The sensitivity-based stress test method will be applied to all banks in Categories 1–4, although with some variations. The results of the stress test will be presented in terms of both risk weights and leverage ratio. See the appendix for more details on the design of the test.

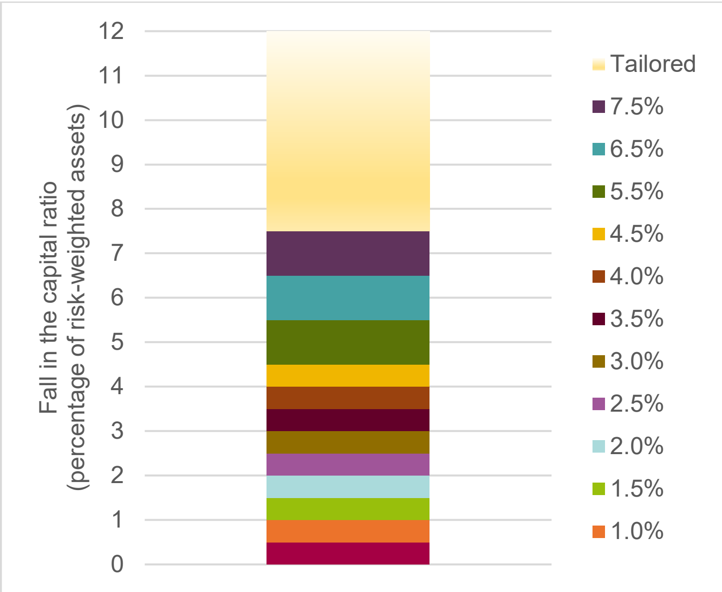
Finally, in terms of *the Swedish Fintech Association's* feedback that FI is not consistent in terms of its choice of terminology in the consultation memorandum with regard to whether it is a fall in the level of capital or the capital ratio that the sensitivity-based stress test method will target, we have clarified that it relates to a fall in the capital ratio.

Buckets for the risk-based guidance
Diagram 2 illustrates the buckets in which FI intends to allocate the banks with regard their risk weight. The increments are 0.5 percentage points up to 4.5 per cent and then 1.0 percentage point up to 7.5 per cent. In the event the total outcome of the stress tests exceeds the latter and the bank is thus placed in the highest bucket, we will make a separate assessment to determine a suitable level.

If a stress test for a bank were to result, for example, in the common equity Tier 1 capital ratio falling by 3.8 per cent, this drop will be rounded to 4.0 per cent. All else equal, in this example, the guidance communicated to the bank, after deducting the capital conservation buffer (which is 2.5 per cent), will be 1.5 per cent.

Rounding the outcomes in this way makes the guidance more stable over time and also increases comparability between banks. It also reflects that the results of the stress test are FI's best assessment of what could happen under hypothetical stressed conditions, but they are not an exact prediction of future outcomes. In terms of the feedback from *the Swedish Bankers' Association* and *the Association of Swedish Finance Houses* that the buckets are too large, FI takes the position that the increments presented in Diagrams 2 and 3 are well-balanced and generate institution-specific results. In terms of how the rounding should be applied, the choice reflects a general principle of prudence.

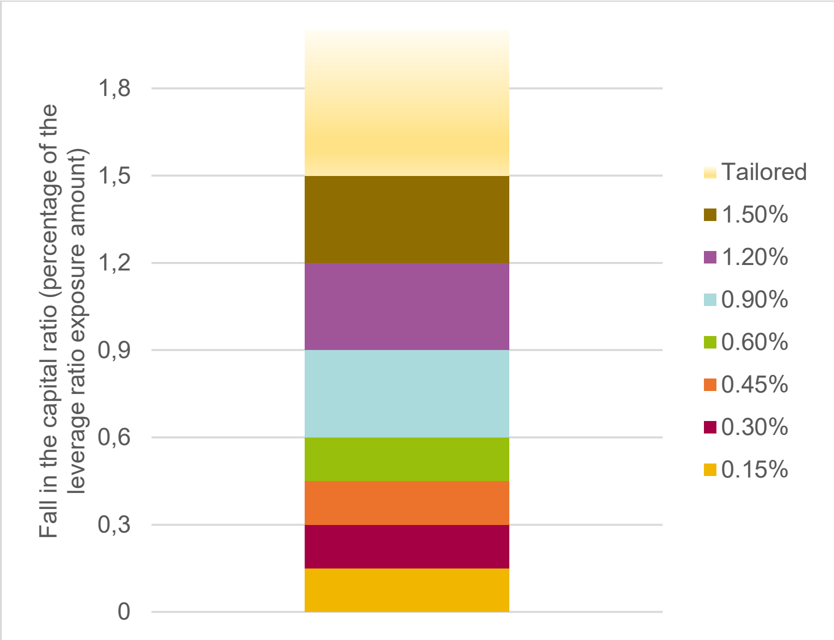
Diagram 2 Buckets for the risk-based guidance



Source: FI.

Buckets for leverage ratio guidance
Diagram 3 illustrates the buckets to which FI intends to allocate the banks based on their leverage ratio. The increments are 0.15 percentage points up to 0.6 per cent and then 0.3 percentage points up to 1.5 per cent. In the event the total outcome of the stress tests exceeds 1.5 per cent and the bank is thus placed in the highest bucket, FI will make a separate assessment to determine a suitable level.

Diagram 3 Buckets for leverage ratio guidance



Source: FI.

2.3 Consideration of other grounds for assessment

FI's position: The starting position for determining the need for a Pillar 2 guidance should be the outcome of the sensitivity-based stress test method. This outcome can be supplemented with additional grounds for assessment in order to both factor in other aspects that are not necessarily reflected by this stress test and be able to adjust any outcomes that for some reason may appear to be unreasonable.

In addition to the outcome of the sensitivity-based stress test method, FI therefore intends to consider in a separate step a number of other and partly qualitative assessment grounds and aspects. Where applicable, we will also consider two additional quantitative assessments in the form of a macro-based stress test performed by FI and the stress test that is led by the EBA.

2.3.1 Feedback received

The Swedish Bankers' Association would like to see additional clarity and details regarding which types of assessments FI may make in the qualitative assessment.

The Swedish Fintech Association takes the position that FI in general allows too much room for qualitative assessments in its method and that the authority is not sufficiently transparent about which grounds of assessment it will use. It asserts that this can lead to uncertainty and a risk that the assessment will become arbitrary. For new actors and companies with non-traditional business models, consideration needs to be given to more qualitative grounds of assessment to be able to generate a fair outcome. This is due in part to the fact that the EBA's stress test and the macro-based stress test are only applied to the major banks. The Swedish Fintech Association also would like more clarity regarding the extent to which FI intends to consider the banks' own internal stress tests.

2.3.2 Reasons for FI's position

Qualitative grounds for assessment
FI considers it to be neither suitable nor possible to mechanically rely on the result of a specific stress test. The quantitative outcome must be reviewed and, if needed, supplemented with other assessment grounds and aspects.

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

Macro-based stress test method
FI uses macro stress tests as a tool to assess individual banks' resilience as well as stability in the financial system. Over the past few years, we have developed a number of models for different components of the banks' earnings, balance sheets and risk-weighted assets. These models have been merged into a single method.[11] In order to assess a suitable Pillar 2 guidance, we will also consider the outcome from the macro-based stress test method for banks in question (primarily the major banks; see below).

The method is similar in several respects to the sensitivity-based stress test method, but it does differ in that its starting point is a severe hypothetical macrofinancial scenario. Just like the sensitivity-based stress test method, the

[11] See the memorandum "Makrobaserade stresstester av svenska banker: resultat och metod hösten 2020" (FI Ref. 20-22103), November 2020, FI, for a description of the model in its entirety and the scenario that the current version uses as its starting point. An English translation is available at www.fi.se.

macro-based method focuses on losses for the banks, changes in their balance sheets, and their main income items. These are set in relation to the development of various macrovariables with primarily historical relationships, but also some assumptions, in order to see how the capital ratios are impacted both in terms of risk weights and the leverage ratio.

This method, as well as the various sub-models, has been based on aggregate portfolio data that the major banks reported to FI as part of their regulatory periodic reporting as well as some data from other sources.

The macro-based stress test method currently can be applied to Category 1 banks and some Category 2 banks. FI intends over time to be able to expand the method to include most banks in Categories 1 and 2.

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

The stress test aims to assess the impact of different types of stress on the banks' capital adequacy. The banks included in the test estimate the impact on credit risk, market risk, counterparty risk, operational risks, and their main income items based on the severe scenario set by the European Systemic Risk Board (ESRB).[12]

FI intends to consider the outcome from the EBA's stress test when assessing a suitable Pillar 2 guidance. In 2021, the test will be applied to Category 1 banks and some Category 2 banks.

3 Use of the capital created through Pillar 2 guidance

It is very important that buffer capital can be used in practice. With the buffers acting as an air bag, the bank gains the time and opportunity to recover from financial shocks. With the Pillar 2 guidance, FI can take action based on an individual bank's situation as well as several different banks' situations. FI can decrease the size of the guidance, if, for example, the risks that led to the communication of the guidance have materialised. We can also be communicative, for example during generally stressed periods, explaining how we intend to act if the guidance is no longer met.

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[12] See EBA (2020), "EBA publishes the methodology for the 2021 EU-wide stress test", November 2020, https://eba.europa.eu/eba-publishes-methodology-2021-eu-wide-stress-test, for more information on the most recent version of the stress test.

Capital is usable in and of itself, but the bank's scope for falling below the capital requirements without FI making the assessment that the bank has failed, or is likely to fail, decreases the further down in the components of the capital requirement the bank is positioned. The Pillar 2 guidance is placed above the minimum requirements and the combined buffer requirement, and, unlike for breaches of the combined buffer requirement, a breach of the guidance is not associated with any automatic restrictions on, for example, dividends or coupon payments on Tier 1 capital instruments. In practice, this means that FI has considerable capacity for taking action based on the specific situation if the guidance is not met. In other words, FI will be able to use this capacity to give the bank time to recover where conditions allow for such.

3.1.1 Feedback received

The Swedish Bankers' Association and *the Association of Swedish Finance Houses* welcome FI's position in this part.

4 Public disclosure

As previously announced, FI intends to disclose the size of a Pillar 2 guidance and the approach used to determine it.

4.1 Size of Pillar 2 guidance

FI currently already publishes on a quarterly basis the memorandum "De svenska bankernas kapitalkrav" for banks that belong to Supervision Categories 1 and 2. The memorandum presents the levels of the banks' capital requirements and own funds at the consolidated level, where relevant, and otherwise at an individual level at the end of each quarter.[13]

In the same manner as for the minimum requirements, the Pillar 2 requirements and the buffer requirements, FI intends to publish the levels resulting from the Pillar 2 guidances for the major banks. The aim is to provide a full overview of the total capital requirements. This practice has also applied until now with regard to the non-decided Pillar 2 requirements. Thus, other actors will be able to determine if a bank is operating with capital that exceeds or falls below the capital level that it has been communicated through a guidance. Such disclosure will also make it clear how much capital the banks is choosing to hold in addition to the total capital requirements. FI therefore intends to publish the guidances that have been communicated to the banks in addition to the other requirements, primarily for the major banks that already today are included in FI's quarterly disclosures.

[13] See the memorandum "De svenska bankernas kapitalkrav, första kvartalet 2021" (FI Ref. 21-12926), 25 May 2021, FI, for more information the most recently published version. An English translation is available at www.fi.se.

4.2 FI's methods
FI will assess a suitable Pillar 2 guidance in conjunction with the SREP for each bank. Furthermore, we intend to the greatest extent possible to account for the methods that were used to determine a suitable size for the Pillar 2 guidance.

This memorandum describes the general approach and the sensitivity-based stress test method. In terms of the other two methods, the macro-based stress test is described on FI's website and the EBA's stress test method is described on the EBA's website.

For the sensitivity-based and macro-based stress tests, FI also intends to publish in conjunction with the closing of the banks' SREPs a calibration memorandum that presents in more detail the numerical variables that were included in the current year's tests since the exact calibration may differ slightly from year to year.

5 Implications of the proposal

The Pillar 2 guidance is part of the regulatory amendments regarding the banks' capital adequacy that went into effect as of 2021. In the capital requirements memorandum, FI presented the implications of the changes as a whole, and this assessment still holds in terms of the impact on both affected firms and FI.

5.1 Implications for the banks
FI makes the assessment that the Pillar 2 guidance for most banks will amount to 1.0–1.5 per cent of their risk-weighted assets and 0.2–0.5 per cent of the leverage ratio exposure amount. These figures may vary between banks and may be lower or higher than the stated intervals.

Given the overall changes from the implementation of the banking package, FI maintains its assessment that the total risk-based capital requirement will not significantly change for the major banks. For most of the other banks, the risk-based requirements could increase by 5–10 per cent, primarily since more banks will receive a Pillar 2 guidance than received a capital planning buffer.

For some banks, the leverage ratio requirement and the leverage ratio guidance may become the most restrictive requirement in practice. However, this is not first and foremost an implication of FI's application but rather a result of the new regulatory framework.

5.2 Implications for FI
The application of the Pillar 2 guidance will create more work for FI, in part since more banks will require an assessment than what was the case under the comparable capital planning buffer. FI makes the assessment, though, that the added costs will be absorbed within the existing framework.

Appendix

Current design of the sensitivity-based stress test method

The sensitivity-based stress test method is broken down into a general method selection and a specific calibration of risk parameters. FI will develop and refine the test on an ongoing basis. A general description of the test's main design is presented in this appendix.

General method selection

The stress test analyses a three-year period and is constructed by changing different risk parameters, with the greatest stress applied in Year 1. There is no underlying macroeconomic scenario, but the calibration of the risk parameters is intended to correspond to a severe but not improbable financial shock. The risk parameters can include, for example, changes in the following:

- Market rates, credit spreads, exchange rates, and asset prices.
- Credit losses and risk-weighted assets.
- Operational loss events.
- Commission income and commission expense but also other important income and cost items.

The starting point for calculating the outcome will be a top-down approach, or in other words the calculations will be done by FI. Data that serves as a basis for the calculations largely consists of the data the banks submit in their periodic reporting. To some extent data will also be gathered in other contexts, for example during the ongoing risk reviews that FI conducts with the banks.[14]

The stress test starts with the balance sheet, income statement and capital situation from the banks' submitted financial data from the previous year(s). The composition of assets and liabilities is in general kept constant, but some growth in assets and liabilities will be included in the calibration where such is justified. For example, FI intends to apply the assumption that the Category 1 banks in particular will replace part of their non-financial customers' maturing market financing through existing credit facilities. For smaller, rapidly growing banks, it can also be relevant to assess future growth, and the assessment of the underlying earnings is then based on several years of historical data.

The outcome in relation to the risk-based guidance is determined as the largest decrease in the common equity Tier 1 capital ratio under stress in the three-year period of the stress test, and the outcome in relation to the leverage ratio

[14] An additional information gathering request may be required to assess aspects related to primarily credit risk and market risk, for example earnings risk with regard to net interest income and changes in the values of market assets, which is not evident in the available information.

guidance corresponds to the greatest decrease in the leverage ratio during the same period.

The change in total earnings after tax and dividends corresponds to the change in the common equity Tier 1 capital. If the firms report a profit, deductions are made for tax in accordance with the current corporate tax, and if there is a published dividend policy, dividends are assumed to be made in accordance therewith.

Specific calibration for banks in Supervision Categories 1 and 2
Described below are several methodology choices that are specific to the banks in Supervision Categories 1 and 2.

Stress applied to earnings
Stressing the underlying earnings affects primarily net interest income, net commission income, and net financial income. The change in net interest income is based on a change in market rates and interest rate margins. For net commission income and net financial income, the assessment will be based primarily on standardised assumptions. It will be necessary to use similar assumptions to assess other sources of earnings, such as lease income, dividends received, and income from investments and joint ventures.

Changes in net pension assets that have been reserved for defined benefit pension schemes impact the banks' own funds through other comprehensive income. Pension assets develop in line with the values of assets, and liabilities are impacted by changes in interest rate levels through the discount rate.[15]

Credit losses and other unexpected losses
FI intends to calibrate the credit loss level using the credit risk data that firms with authorisation to use an internal ratings-based approach to assess their capital need for credit risk in Pillar 1 submit to the authority. This assessment can also be impacted by reported historical losses for the Swedish banks. It is also possible that we will use information from microdata analysis of households and corporate exposures that we have access to or will have access to in the future. The loss ratios (credit loss key) used are primarily bank-specific for the major banks and aggregate for Category 2 and the other institutions in Category 1.

The assessment of operational losses is calibrated to a certain percentage of historical net income.

Stress applied to assets and liabilities in the balance sheet
An assumption is made that there will be some growth in the balance sheet of Category 1 banks in the form of replacing past-due market financing of

[15] FI can take into consideration the banks' assumptions regarding the discount rate as well as actuarial assumptions, for example future inflation.

existing large corporate clients. The assumption is based on the banks acting in this way for commercial reasons, for example to maintain long-term customer and investor relationships, minimise reputation risk or reduce a potentially greater loss on already issued loans by issuing more loans to help a customer through a financially challenging situation.

Stress applied to risk-weighted assets

In addition to the impact on the composition of the balance sheet, the risk-weighted exposures for credit risk can be influenced by changes in various risk parameters. The risk weights increase due to the credit risk migration for the portfolios where the credit risk is covered using internal ratings-based models. The increase in the risk-weighted exposure amount is subdued by the risk weight floor for Swedish mortgages in Pillar 1 and will also be influenced by the introduction of the risk weight floor for commercial real estate exposures.

Risk-weighted assets can be impacted if the accounting currency depreciates. Furthermore, past due credit exposures are allocated a risk weight of zero for credit portfolios where the firms are allowed to use an internal ratings-based model.

Specific calibration for banks in Supervision Categories 3 and 4

The proposed method for the banks in Categories 3 and 4 is based on the method applied to the banks in Categories 1 and 2 but with some simplification. This is partly because some risks are less relevant for banks with more limited business models compared to the major banks. For example, the model is not expected to lead to an increase in the risk-weighted exposure amount for credit risk for banks that do not apply internal models. The pension risk is also judged to be small.

The method applied to stress earnings is similar to the method for the larger firms since it is largely based on data from the periodic reporting. Since the smaller firms in particular experience large fluctuations in earnings over time, FI finds it reasonable to assess the underlying earnings as an average over several previous years (depending on the available data). Some banks in Categories 3 and 4 have significant leasing operations, to which stress will also be applied explicitly.

For some smaller companies, primarily those that have a large percentage of consumer credit loans with high risk in their lending, the calibration of the credit loss level will be adjusted compared to the larger banks.