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Swedish Capital Requirements: Tough for a Reason

Scope believes Swedish banks are amongst the best capitalised in Europe, at least based on a headline comparison of capital ratios. However, they also face some of the steepest capital requirements, partly due to the frontloading of CRR/CRD IV, but also due to the cautious approach taken by Sweden's supervisory authority Finansinspektionen. As a result, they hold little excess capital compared to their requirements.

This report, which builds on our previous note *"The State of Bank Capital in Europe, Requirements by Country"*, looks at capital requirements in Sweden, giving a succinct view of what risks the various buffers address and where the capital debate stands.

We believe there are peculiarities of the Swedish system that warrant the cautious approach taken by Finansinspektionen. For example, Sweden has a very large (relative to GDP) and interconnected financial system, with the four large banks – Nordea, Swedbank, SEB and Handelsbanken – in the middle with significant reciprocal holdings of covered bonds. The reasons for this include the system's concentration, its large funded pension system, which intermediates households savings into bank's liabilities, as well as the historically strong performance of Swedish covered bonds. The 5% capital buffer requirement for systemic risk is hence well justified.

In addition, the country's household sector is highly leveraged, the result of years of rising property prices and mortgage lending growth (see our note *"Swedish Property Market Poses Risk to Bank Fundamentals"*). With the central bank busy battling deflation and policy interest rates below zero, macro-prudential tools – including a countercyclical buffer of 1% – are deployed to limit credit growth.

Another key debate is the continuous decline in the average RWA content of Swedish banks' credit portfolio. We calculate the average RWA intensity for the four large banks has declined from 37% in 2007 to 20% in 2014 and is now well below the average for European banks. This is partly a result of product mix, but we note that even within the same exposure class there has been a noticeable drift in the input parameters of internal models. In our view this reveals an important flaw of the risk weighted framework, namely pro-cyclicality in input parameters estimation. The mortgage risk floor requirements under Pillar 2 address this issue. These are institution specific buffers and include floors on RWA for mortgages in Sweden and Norway. The associated capital buffer requirements range from 1.1% at Nordea to 5.3% at Swedbank.

We believe that the current approach of adding risk-sensitive buffers through Pillar 2 requirements is inherently more effective from a prudential perspective than non-risk sensitive measures of risk, like a simple leverage ratio, as it encourages better risk origination, monitoring and management. While useful as a risk backstop measure, we believe the simpler and more transparent leverage ratio is less informative of the true capitalisation of a retail bank.

Overall, we believe that the strict capital regime is appropriate given peculiarities of the Swedish system and that it boosts banks' credit profiles. Scope's ratings and analysis of Nordea (A+; Stable Outlook), Handelsbanken (A; Stable Outlook) and Swedbank (A-; Stable Outlook) reflect such strength. At the same time, we note that the more limited levels of excess capital represent an additional potential risk factor for holders of Additional Tier 1 securities. For these securities, coupon payment is discretionary and in any case prohibited if the bank were to breach minimum requirements, including at least some of the buffers. For this reason, we generally see the Swedish banks' approach to hold even higher capital buffers than required to allow financial flexibility with respect to distributions positively.

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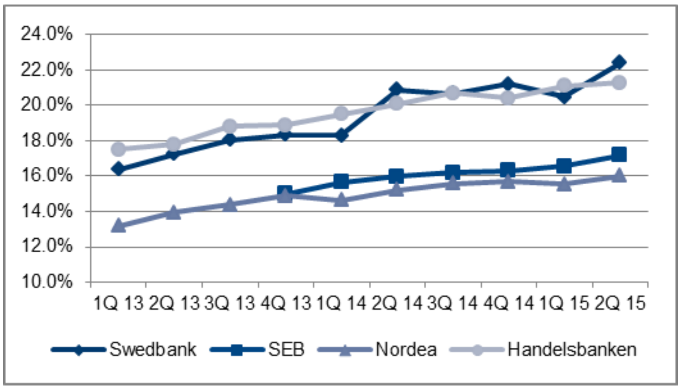
High capital ratios, matching high requirements

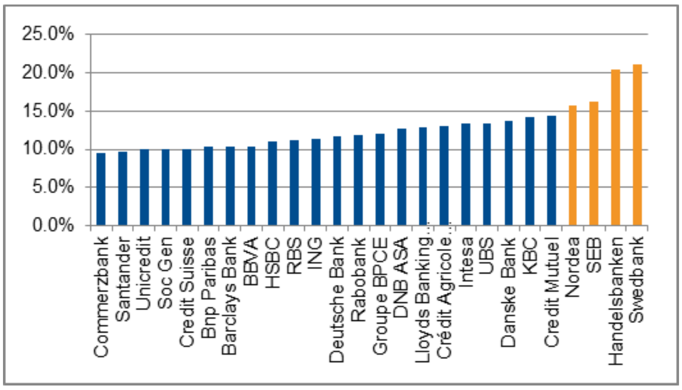
Swedish banks' capital ratios have increased substantially over the past few years. Compared to international peers, including in the Nordic region, all large Swedish banks display reassuring capital metrics, with the CET1 ratio ranging from 16% at Nordea to 22.4% at Swedbank at the end of Q2 2015. This is the result of strong organic capital generation, despite generous dividend pay-out policies, also helped, in recent years, by declining RWA intensity.

Chart 1: Swedish banks CET1 ratios, historical evolution



Source: Company data, SNL financial, Scope Ratings

Chart 2: CET1 ratios, European banks (2014)



Source: Company data, SNL Financial, Scope Ratings

The drive towards higher capital ratios is also due to the gradual introduction of higher requirement levels by Finansinspektionen.

On a quarterly basis, Finansinspektionen publishes updated capital requirements for Swedish banks. These include the standard CRD IV requirements, the level of the required buffers as well as Pillar 2 requirements for banks. Over the past few years, the supervisory authority has been gradually increasing its requirements for Swedish banks.

At present, the minimum CET1 requirement consists of:

- CRD IV minimum requirement of 4.5%
- Capital conservation buffer of 2.5%
- Systemic risk buffer of 5% (of which 3% under Pillar 1 and 2% under Pillar 2)
- The countercyclical buffer is currently set at 1% for Sweden, but Finansinspektionen has proposed to raise it to 1.5% in 2016. At institutional level, it ranges from 0.4% at Nordea to 0.7% at Swedbank, and reflects the banks' different geographic mix.
- Mortgage risk floor requirements under Pillar 2. This is institution-specific and includes floors on RWA for mortgages in Sweden and Norway, both currently set at 25%. The associated capital buffer requirement ranges from 1.1% at Nordea to 5.3% at Swedbank.
- Other Pillar 2 own-fund requirements. This was set initially at 1.5% for all institutions. In May 2015, SFSA detailed the calculations for pension risk, concentration risk and interest rate risk in the banking book. In its May capital markets day, Nordea disclosed its CET1 requirement for these three risk amounts to 0.7% of RWAs, although it added that it still considers the rest of the 1.5% (80 bps) applies as a requirement to cover other Pillar 2 risks. For other banks, the own-fund requirement for these three risks is estimated at between 1.5% for Swedbank and 2.1% for Handelsbanken and we do not add additional Pillar 2 risk buffers for residual SREP risks (as in Nordea's case) ahead of clarification from Finansinspektionen. In its September memorandum, the authority said it will publish institution specific requirements in Q3 2015.

Our total CET1 requirement estimate, which includes both Pillar 1 and Pillar 2, ranges from 14.9% at Nordea to 19.5% at Swedbank, based on the September 2015 memorandum and Finansinspektionen indications on standardised Pillar 2 risks from May 2015. (For detailed capital requirements for the four large private Swedish banks see Appendix 1, page 7).

While headline capital ratios are high, the distance to the current capital requirement is no higher than European peers, in fact, it is lower. This is because Sweden has frontloaded CRD IV implementation, including the introduction of the different buffers and added additional layers of protection, the so-called 'Swedish golden finish'. This is an important factor supporting the credit of Swedish banks, but paradoxically also entails relatively higher risk to holders of Additional Tier 1 securities with respect to coupon distribution restrictions.

Given the above, one may be tempted to conclude that the Swedish supervisory authority is overly cautious and in doing so is imposing unfair burdens on the banks. This is not our view. The Swedish financial system is exposed to structural systemic vulnerabilities that justify very cautious approach by regulators.

Significant monetary policy challenges, leaving macro-prudential tools to address financial stability

A countercyclical buffer requirement of 1% applies in 2015, and Finansinspektionen has proposed raising this to 1.5% in 2016. This particular capital requirement appears to be a macro-prudential response to a system that is showing signs of overheating.

Currently, Sweden is experiencing mild deflation, with CPI inflation at or below 0% since late 2012, consistently below the Riksbank's (Sweden's central bank) target of 2%. Responding to the deflationary threat, the central bank has repeatedly cut its reference interest rates. The repo rate currently stands at a negative 0.35% and the Riksbank indicating that it is prepared to reduce it further should it deem it necessary. Moreover, the Riksbank launched a quantitative easing program in 2015.

However, by reducing the cost of accessing and servicing credit, the expansionary monetary policy encourages leverage and risks inflating asset prices faster than incomes. Rising real estate prices are the most straightforward example, as we discussed in our report "*Swedish Property Market Poses Risk to Bank Fundamentals*".

However, we believe that bank capital requirements alone may not be the best tool to curb credit excesses, as they largely affect the supply and cost of credit by banks but do not alter demand. The risk is that part of the demand is then fulfilled by non-bank players, which may fall outside of the supervisory perimeter.

We note that there have been attempts to curb mortgage demand and hence household leverage by imposing mandatory amortisation requirements, which have been unsuccessful so far due to legal challenges to the supervisor's authority to impose them (although banks generally seem to have voluntarily taken up the practice of forcing amortisation of mortgages).

In its latest decision regarding the countercyclical buffer rate, Finansinspektionen explicitly mentions "the increasing indebtedness linked to increasing house prices poses a heightening risk to the Swedish economy" and that "an amortisation requirement should be introduced as soon as possible to dampen the economic risks linked to household debt"[1].

Another key element boosting demand for credit seems to be the tax deductibility of mortgage interest. Reducing or removing that could help put a brake on Swedish households' apparently insatiable demand for housing credit. We also think that loosening the supply constraints in the rental market of big cities would dampen property price growth and the need for households to borrow.

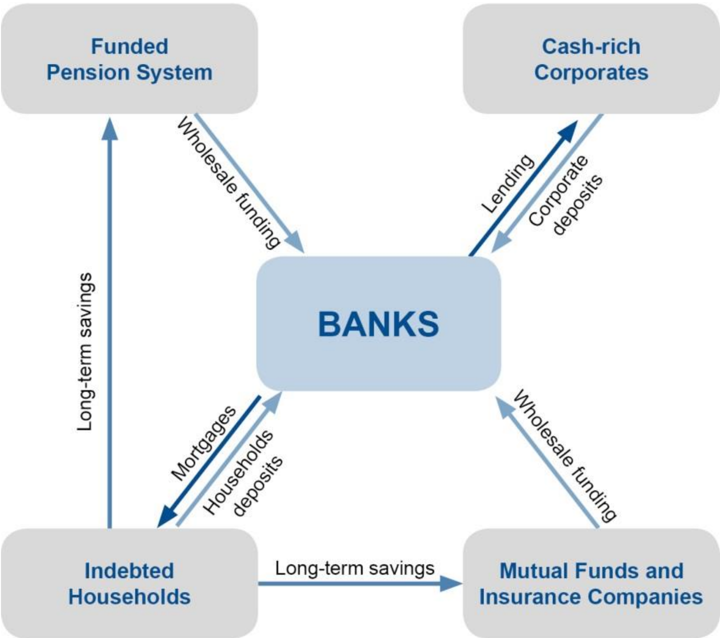
[1] FinansInspektionen,"Decision regarding the countercyclical buffer rate", 8 September 2015

A large and interconnected financial system, which relies on a wholesale funding loop to recycle long-term savings into real estate investment through bank liabilities

The high buffer requirements for systemic risk reflect the peculiar structure of Sweden's financial system.

Swedish banks' consolidated assets amount to almost 400% of GDP, high by international standards. The system is highly concentrated, with the four major banks dominating the system. Banks are generally exposed to the same risk segments, have largely similar business models and hold direct exposures to each other's covered bonds, the main source of liquid assets in krona. In addition, banks rely on wholesale funding from institutional investors, including domestic pension funds and insurance companies, but also international investors. These wholesale funds, including a large proportion of covered bonds, which have historically performed well, represent mostly "recycled" long-term households savings in the form of pension contributions or life insurance products. Given the potential disruption to the system if one of the large banks ran into difficulties, it is not surprising the prudential authorities require banks have additional buffers for systemic risk.

Chart 3: Savings recycling mechanism in Sweden

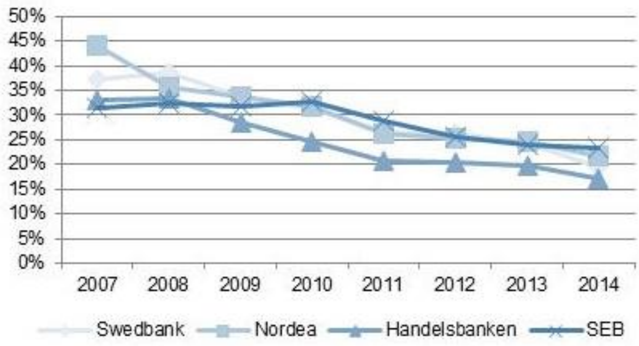


Source: Scope Ratings

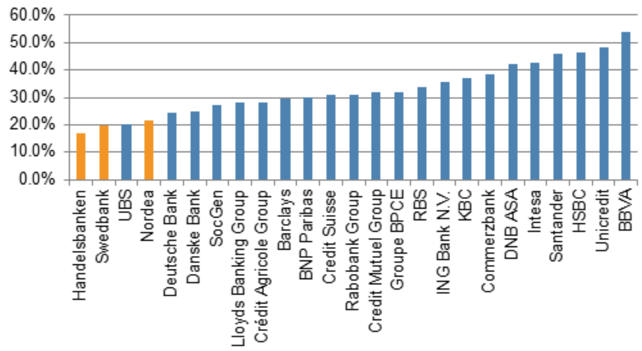
A growing disconnect between weighted and unweighted measurement of on-balance sheet risk

The debate about the limits of the risk weighting framework is highly relevant for Swedish banks. Over time, the internal model calculations of PDs and LGDs have produced a significant decline in RWA intensity. This is true for all four large banks. While it is generally possible for a bank to materially change its risk profile over time by changing its product mix or positioning within a market, we doubt that credit risk can materially decrease for the whole market. We calculate that since 2007 the average risk weight intensity for the four major banks has declined from 37% to 20%. This was partly the result of the migration of exposures to the advanced IRB approach as well as of a change in product mix towards secured retail exposures. However, looking at individual product segments within the banks, we note a decline in the estimated inputs (PD and LGDs), which in our view reveals an important flaw of the risk weighted framework, namely the pro-cyclicality in input parameters estimation.

Chart 4: RWA intensity has been declining and is at the lower end of European peers



Source: SNL, Scope Ratings



Source: SNL, Scope Ratings

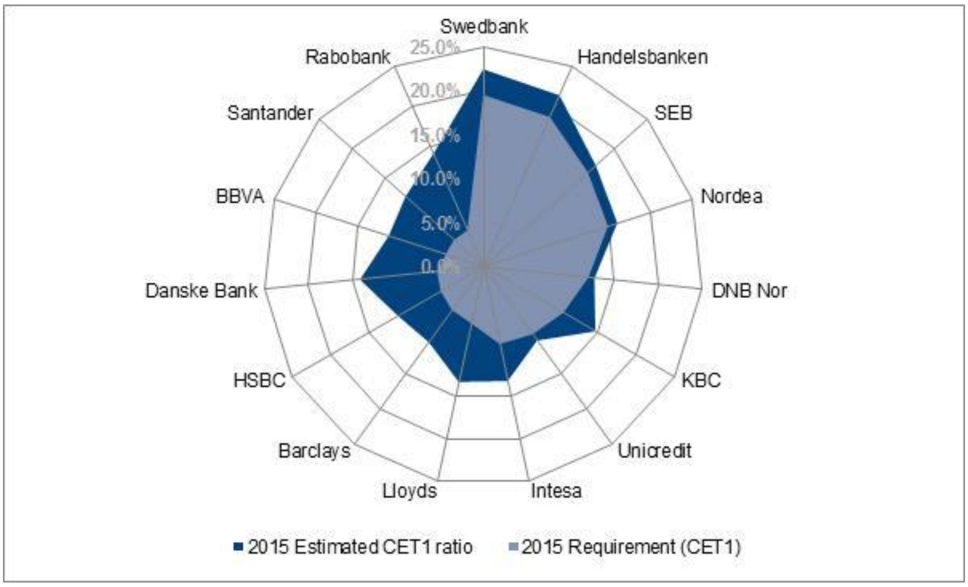
Overreliance on risk-insensitive leverage measures would be a simplistic step back

Scope believes that the risk weighting framework has improved internal risk management and capital allocation for European banks, including in Sweden, and that the benefits of a risk-sensitive capital framework far outweigh costs. At the same time, we acknowledge the need to refine the estimation models in order to limit procyclicality of capital requirements and level the playing field between banks. The buffers for RWA floors for mortgages in Pillar 2 aim at addressing this problem. It is possible that additional buffers will be introduced in the future for corporate risk weights.

Management buffers: a key protection for AT1 bondholders

From our credit analysis perspective, the debate around capital requirements is especially relevant for the purpose of assessing the risk of coupon nonpayment with respect to AT1 notes. For these securities, payment of interest is discretionary, and is prohibited if such payment would cause a breach of applicable banking regulations. For most of the banks we rate, this is at present a relatively minor issue, as most of the Basel III/CRD IV buffer requirements are yet to be introduced. However, due to the supervisory frontloading of such buffers, as well as the addition of the above mentioned Pillar 2 requirements, the excess capital for Swedish banks is generally more limited. (See chart 5, comparing Swedish banks' CET1 excess over the requirement to other European banks).

Chart 5: Distance to CBR/Minimum CET1 requirement, selected European banks



Source: Scope Ratings estimates

The light blue area represents the CET1 requirement we believe could trigger a cancellation of coupons for AT1 securities, while the dark blue area represents the excess capital above that level. Of course, the chart represents a snapshot of the expected situation in 2015. We should emphasise that while the requirements for most peers will go up in the coming years as the CRD IV buffers are gradually phased in, Swedish capital requirements should not, in theory at least, move substantially as most of the CRD IV requirements are already incorporated into the current regulatory demands.

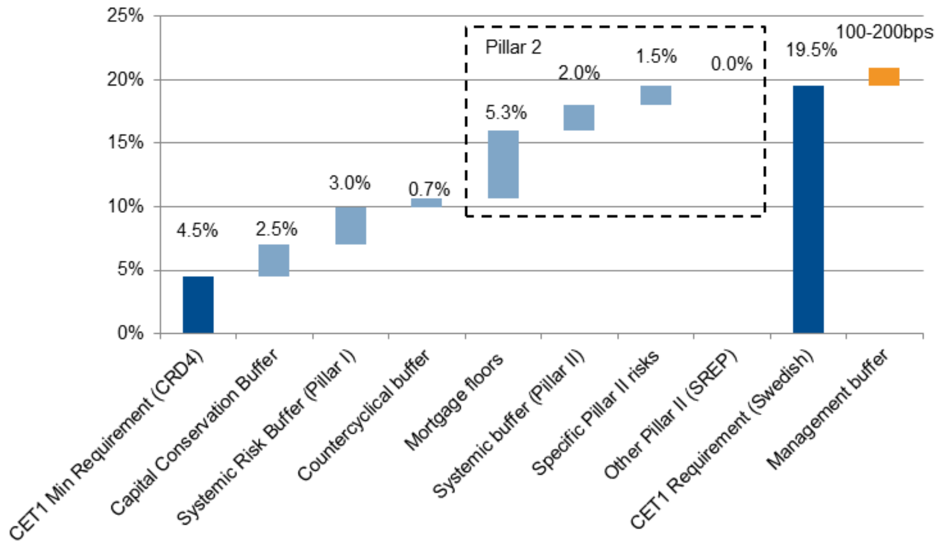
Additionally, we note that there remains uncertainty over whether the Finansinspektionen would effectively limit AT1 distributions in case of a breach of Pillar 2 buffers. Our assumption is that in case of a systemwide decline in capital ratios, some of the Pillar 2 requirements could indeed be regarded as buffers rather than hard constraints. However, if the breach were to be the result of an idiosyncratic problem at one of the banks, we would see a heightened risk of a mandatory suspension. For this reason, we regard some additional management buffers to be necessary. The four major banks have indicated they plan to maintain such buffers, although these vary in size:

- Handelsbanken is targeting a buffer of 100-300 bps;
- Swedbank aims to keep 100-200 bps of excess capital above the minimum requirement;
- SEB is looking at a buffer of 150 bps;
- Nordea is targeting a buffer of 50-150 bps.

Appendix: Individual banks capital requirements

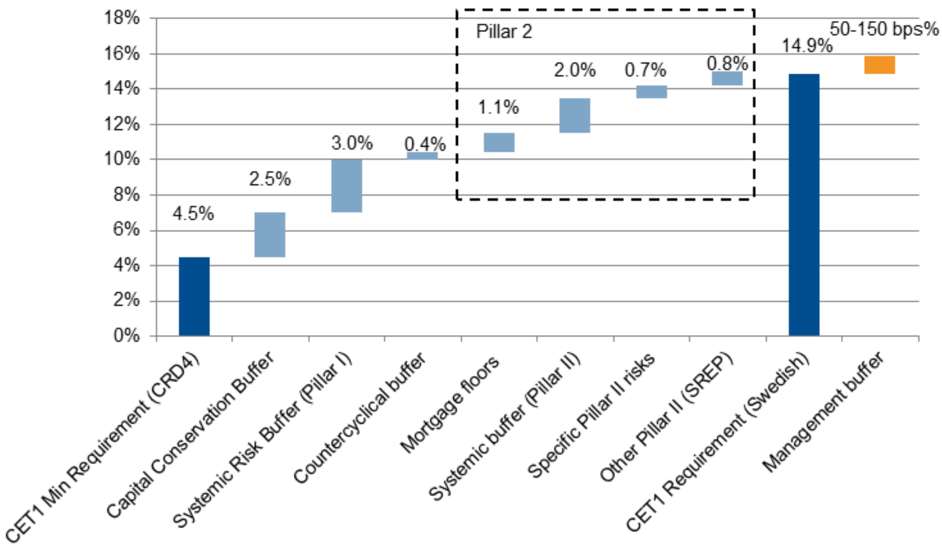
In this appendix, we present a detailed build-up of the CET1 requirement for the four large Swedish banks. This is based on the memorandum published on 2 September 2015 by Finansinspektionen, but the requirements published by it are adjusted to account for other Pillar 2 risks: credit concentration, pension risk and interest rate in the banking book, which we expect to be published shortly. These requirements are estimated based on indications given by the authority on 2 May 2015.

Chart 6: Swedbank CET1 requirement



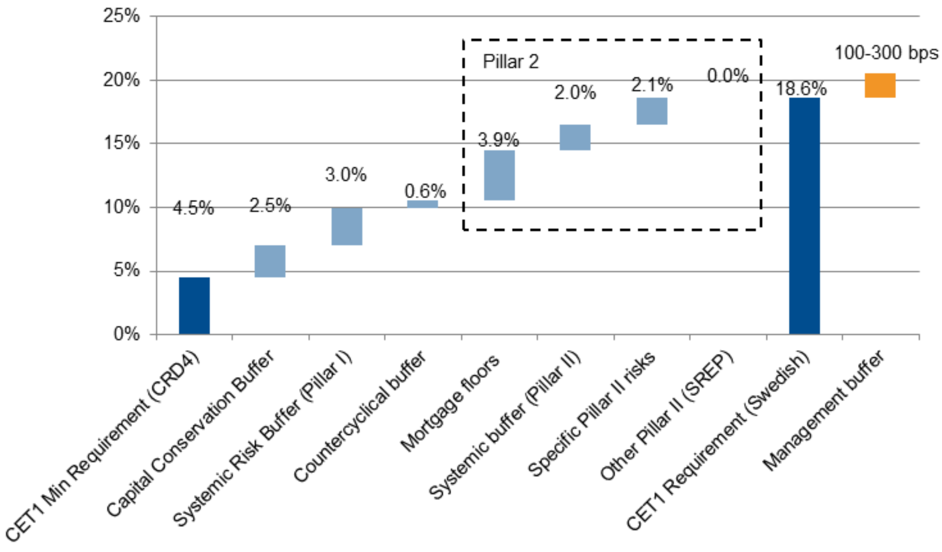
Source: Swedbank, Finansinspektionen, Scope Ratings estimates
Note: based on September 2015 memorandum

Chart 7: Nordea CET1 requirement



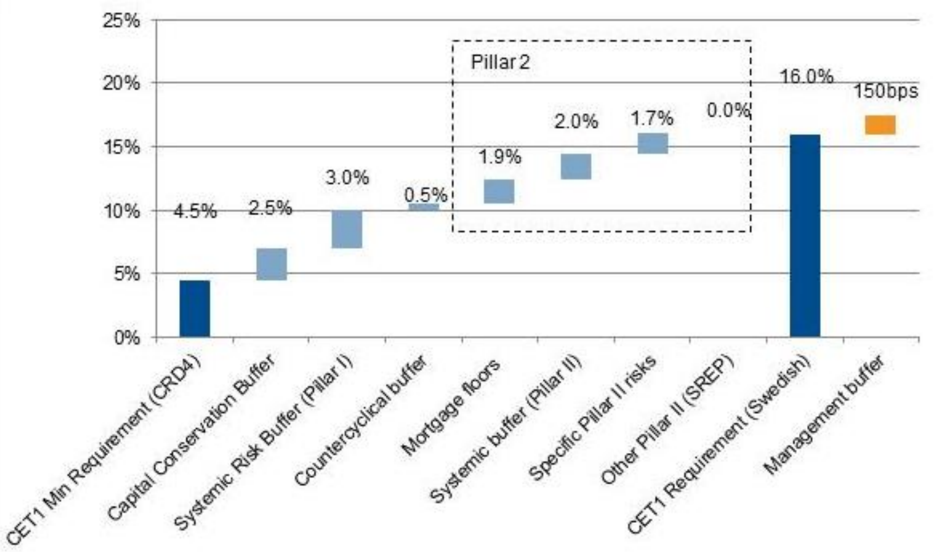
Source: Nordea, Finansinspektionen, Scope Ratings estimates
Note: based on September 2015 memorandum

Chart 8: Handelsbanken CET1 requirement



Source: Handelsbanken, Finansinspektionen, Scope Ratings estimates
Note: based on September 2015 memorandum, adjusted upwards to reflect the indicated higher requirement for standardised Pillar 2 risks (2.1% vs 1.5% standard value).The final requirement for standardised Pillar 2 risks should be finalised in Q3 2015

Chart 9: SEB CET1 requirement



Source: SEB, Finansinspektionen, Scope Ratings estimates
Note: based on September 2015 memorandum, adjusted upwards to reflect the indicated higher requirement for standardised Pillar 2 risks (1.7% vs 1.5% standard value).The final requirement for standardised Pillar 2 risks should be finalised in Q3 2015

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