REGERINGSKANSLIET
Ministry of Finance

Finansmarknadsavdelningen

Swedish Financial Supervisory Authority

Financial Stability Department

Response by Swedish authorities to the Commission services

Consultation regarding further possible changes to the Capital Requirements Directive (CRD)

Introduction

The primary Swedish authorities involved in banking regulation are the Ministry of Finance, Sveriges riksbank (the national central bank), and Finansinspektionen (the financial supervisory authority) (together hereafter the Swedish Authorities). We have jointly drafted and agreed on the following Response to the Commission services' Consultation regarding further possible changes to the Capital Requirements Directive (CRD).

The Swedish Authorities' objective with this Response is to provide our overall view on the proposals as well as comments on specific issues in which we take particular interest. We have made general comments on each of the Chapters (main issues) as well as commented on the individual numbered questions of the Commission services' Paper.

As a general caveat we want to stress that since the whole package of measures to strengthen the resilience of the financial system is not yet complete even in draft form, our views should be regarded as tentative. On some issues, for which the plans still are quite vague, we have provided our preferred directions how to proceed but we have avoided specificity. In addition to awaiting more concrete proposals we also await the outcome of the quantitative impact studies (QIS), which will guide our views. The combination of the ongoing "bottom-up" and a "top-down" QIS approaches will presumably provide a comprehensive picture on the effects of the proposed measures not only on the banks per se but also on the overall financial system and the macro economy.

Major overarching issues

Apart from the answers on the individual questions, the Swedish Authorities would like to emphasise the following overarching points:

First, we strongly support the proposals to strengthen the CRD in order to ensure overall stability in the financial system as well as in individual institutions. The recent global financial crisis revealed a large number of weaknesses in existing regulations, which need to be fixed. Furthermore, the increasing integration of financial systems, both across sectors and across jurisdictions, is a positive development but needs to be balanced by commensurate regulation and supervision. In this vein harmonised

legislation, also across sectors and across jurisdictions, will promote financial sector efficiency and stability. Furthermore, we support that the Directive will delegate the powers to draft legally binding guidelines, on a number of specified issues, to the new micro prudential authority (EBA). This will further enhance harmonised application.

Second, to ensure a global level playing field but also to promote the efficiency of international financial operations it is important that fundamental regulatory principles are implemented not only by the EU but globally. Hence, the Swedish Authorities strongly support the objective of securing close alignment between the rules set by the EU and the framework agreed upon by the Basel Committee on Banking Supervision. Since the deliberations of the BCBS are still going on, the Commission must be prepared to adjust its proposals to the CRD accordingly. That said, we find the current process suitable, i.e. that the EU in order to gain time works in parallel with the BCBS.

Third, a fine-tuned timing of the implementation of the proposals is crucial. A balance must be struck between on the one hand the need to enhance the resilience of the banking sector through stronger regulation and on the other hand the current de facto financial weakness of the sector which presently makes it difficult to increase regulatory requirements and costs. In addition, there is a challenge in implementing the measures at a time when the global supply of sovereign debt is expanding. While the Swedish Authorities generally support the Commission services' approach aiming for a 2012 implementation of the total package of measures, we are flexible if it should prove appropriate to "split the package" and to prioritise some urgent measures such as strengthening liquidity and capital.

Fourth, we note that almost all of the proposals for amending the CRD go in the same direction – towards stricter requirements leading to increased costs for banks and for conducting bank activities. While we agree that such steps are necessary, at some stage the regulatory framework will arrive at a point where further strengthening of the banking system can only be obtained at the cost of reducing its capacity to meet legitimate financing needs of households and companies. Hence, the ultimate calibration of the amendments must await and take into account the results of the on going "impact study". The impact study must not only be quantitative but also qualitative, for instance by obtaining assessments from market participants. Will investors react to higher regulatory capital requirements by raising their own "comfort level" even higher – and in that case by how much – or will they continue to apply their present requirements? How will requirements for potential conversion to shares affect the supply and pricing of various capital instruments?

Fifth, the Swedish Authorities would prefer to extend the definition of liquid assets under the liquidity regulations to covered bonds. In our view, covered bonds in many countries fulfil strict criteria in terms of quality and liquidity and should thus be eligible as liquid assets within this regulatory framework. A too narrow definition would create unnecessary risks and problems.

Sixth, we support the overall ambition of strengthening the own funds of banks. In this vein, our primary concern is to raise the level of the common equity component of Tier 1. In addition, we also support the endeavours, provided that they pass the objective tests, to introduce new forms of capital such as contingent capital that will be able to absorb losses on a going concern basis.

Seventh, the Swedish Authorities believe that a non-risk based supplementary measure would, at least until the effects of the ratio have been properly tested and evaluated, have most of its potential leverage restraining effect as a Pillar 2 and Pillar 3 tool, acting as a common indicator system. We also prefer using a wide gross exposure measure and a narrow capital measure in the calculation of the leverage ratio.

Liquidity standards

The Swedish Authorities welcome the proposal concerning liquidity standards. The financial stability will be strengthened by introducing strict quantitative liquidity buffers, better matched maturities and increased transparency. That said, the Swedish Authorities consider that certain issues should be contemplated before implementing the standards in order to ensure that the objective of the proposal is met without excessive negative side-effects.

In calibrating the requirements, the overall market effects have to be considered. Banks will probably feel obliged, for reasons of market confidence, to hold liquid assets in excess of the minimum requirement. In the definition, it is also important to reduce the possibilities for regulatory arbitrage. The development of future products that the banks might create in order to avoid the effects of the legislation must be monitored. Each new product that may impact the liquidity ratio should be questioned by the authorities from a liquidity risk perspective.

Question 1: Comments are sought on the concept of the Liquidity Coverage Requirement and its likely impact on institutions' resilience to liquidity risk. Quantitative and qualitative evidence is also sought on the types and severity of liquidity stress experienced by institutions during the financial crisis and – in the light of that evidence – on the appropriateness of the tentative calibration in Annex I. In particular, we would be interested in learning how the pricing of banking products would be affected by this measure.

The financial crisis has made it evident that banks underestimated their liquidity risk and that liquidity risk management needs improvement. The liquidity buffers in several banks have been of poor quality and to a large extent bank funding has been short-term. During the financial crisis, central banks have been forced to provide liquidity to compensate for shortfalls in funding from other sources. While this was an exceptional case, it is not acceptable that the banking sector, other than in exceptional cases, should depend on support from public authorities. If the Commission services' proposals concerning liquidity standards are implemented it will give credit institutions and relevant authorities a certain amount of time to manage liquidity problems within a bank. It will also enhance the resilience in the financial system both by reducing contagion risk and by increasing confidence among counterparties. If market participants are aware that banks hold high quality liquidity buffers, it will thus reduce the risk of liquidity shocks to individual banks as well as to the banking system. In addition, the increased transparency is positive for investors, customers and other stakeholders and it also adds to market discipline.

The calibration of the Liquidity Coverage Ratio is based on a fairly severe scenario even compared to the past financial crisis. For instance, the liquidity constraints experienced by Swedish banks during the crisis did not approach these levels. The impact study will provide further evidence of the impact, but it is important to ensure

that the levels are appropriate and that the interplay with capital requirements is taken into account.

While the levels may be appropriate for large, international banks, the proposal might be less suitable for smaller institutions. We therefore support looking into the application of the proportionality principle on this requirement.

Question 2: In particular, views would be welcome on whether certain corporate and covered bonds should also be eligible for the buffer (see Annex I) and whether central bank eligibility should be mandatory for the buffer assets?

The Swedish Authorities are of the opinion that all assets allowed to be included in the buffer must fulfil criteria of high quality and liquidity (such as rating requirement, maximum price decline over a 30 day period and bid offer-spreads etc). In addition, we believe that central bank eligibility should be a necessary but a not sufficient condition for buffer assets.

The Commission services' narrow alternative suggests that, in principle, the only eligible assets in the liquidity buffer would be cash, claims on central banks and sovereign and central bank debt instruments. The Swedish Authorities believe that such a definition of eligible assets is too narrow. There are examples of other instruments that fulfil these criteria of high quality and liquidity and which should be included. A too limited definition may create some unintended problems.

- One problem is that the total outstanding volume of domestic eligible assets in some countries is too small in order to meet the banks' needs of liquidity buffers. The Swedish Authorities find it unreasonable to force a country's banking sector to invest in debt denominated in foreign currencies thus containing foreign exchange and transfer risks in order to meet the proposed Liquidity Coverage Ratio. Also smaller countries must be allowed to make use of the liquid markets they have.
- Another problem with excluding other liquid markets is that the diversification of the banks' liquidity buffers will be reduced more than necessary. Hence, the risk for contagion effects may increase.
- A third problem is that the regulation may change the relative pricing of different types of liquid instruments in an undesirable manner.
- A fourth problem is that a too narrowly defined buffer may create problems in terms of sharp reductions in market values when banks have to draw on their buffers ("fire sales").

One example of instruments that typically fulfil the stringent eligibility criteria is covered bonds. Many banks, including the major Swedish banks, fund themselves to a large extent through covered bonds. Covered bonds are normally subject to extensive special legislation to ensure the quality of the asset. A key distinction of the Swedish covered bond market is that banks issue covered bonds on tap using contracts with a fixed set of market makers. For issuers, this format allows them to tap the market in small to medium sizes on a frequent basis. For investors, the tap market means easier asset and liability management through the ability to match assets and liabilities on a small scale without having to fully resort to infrequent, and sometimes uncertain, benchmark issuance as is common in the international market. Most importantly,

during the entire recent global crisis period, the Swedish covered bond market has functioned well. In the secondary market, bid/offer-spreads did not exceed 10 basis points on any occasion. According to the Riksbank's turnover statistics, covered bonds held up well during the crisis compared to government securities. In the primary market, the Swedish banks continued to issue covered bonds during the crisis. The new issuance volume increased during 2008 as well as 2009 compared with pre-crisis levels. Currently the amount of outstanding covered bonds is twice as large as the Swedish government bond market. With reference to the arguments above, the Swedish Authorities believe that covered bonds that pass the eligibility criteria should be included in the liquidity buffer.

Question 3: Views are also sought on the possible implications of including various financial instruments in the buffer and of their tentative factors (see Annex I) for the primary and secondary markets in which these products are traded and their participants.

Clearly, the instruments which will be deemed "eligible" for fulfilling the liquidity requirements will become more attractive and will thus be priced more favourably, contrary to non-eligible instruments. Such results may be unavoidable, but the pros and cons should be made clear before taking a decision on which instruments to include. A decision to go forward with a narrow definition will favour sovereign debt over other types of high quality liquid assets. Possible demand driven lower yields on sovereign debt will also negatively affect life insurance industry which would be required to discount their liabilities with an artificially low risk free interest rate, thus increasing the size of the liabilities and reducing the capital buffer accordingly.

Question 4: Comments are sought on the concept of the Net Stable Funding Requirement and its likely impact on institutions' resilience to liquidity risk. Quantitative and qualitative evidence is also sought on the types and severity of liquidity stress experienced by institutions during the financial crisis and – in the light of that evidence – on the appropriateness of the tentative calibration in Annex II. In particular, we would be interested in learning how the pricing of banking products would be affected by this measure.

The Swedish Authorities are concerned that the calibration of the Net Stable Funding ratio may be too harsh and that it would require such adjustments from significant banks that it could have negative effects on the economic recovery. The calibration of the ratio requires careful consideration and a significant adjustment period in order to reduce unwanted consequences for the real economy.

The present proposal seems to lead to substantial "cliff effects". Consequently, banks might be induced to shorten the duration on their assets (for example cutting the maturities on corporate lending to less than one year) and thus transfer liquidity risk to the customers.

Also, the definition of the Net Stable Funding Ratio opens up for possibilities of unwanted regulatory arbitrage. For example, banks can create funding products that according to the liquidity standards would be defined as long term funding (in excess of a year) but that contains an option for the investor to withdraw the funds within twelve months. In practice, this would mean that long term funding rapidly could turn into short term funding in a crisis situation.

We think that a binding technical standard of the EBA is necessary to ensure that banking products are treated in the same way in the EU for the purposes of calculating NSFR. Such standards may look into the appropriateness of the requirement for smaller institutions and the application of the proportionality principle on this requirement.

Finally, the Swedish Authorities would like to point out the need for harmonisation regarding the measures and sanctions for violations of the liquidity requirements.

Question 5: Comments are in particular sought on the merits of allowing less than 100% stable funding for commercial lending that has a contractual maturity of less than one year. Is it realistic to assume that lending is reduced under liquidity stress at the expense of risking established client relationships? Does such a differentiation between lending with more and with less than one year maturity set undesirable incentives that could discourage for instance long term funding of non-financial enterprises or encourage investment in marketable securities rather than loans?

The Swedish Authorities want to stress that it is important to design quantitative requirements, such as the Net Stable Funding Ratio, in order to achieve the desired effect while avoiding both cliff effects and possibilities for regulatory arbitrage. At the same time it is important to keep the measure simple. One possible way forward would be to differentiate between maturities of less and more than one year but this will not completely eliminate the problem of cliff effects and would also make the measure a little bit more complicated. Furthermore, any differentiation is likely to affect the incentives of banks in important ways. The Swedish authorities therefore favour more explicit studies on such effects before deciding on the merits of any differentiation.

Question 7: Do you agree that all parameters should be transparently set at European level, possibly in the form of Technical Standards by the EBA where parameters need to reflect specific sub-categories of retail deposits?

Yes, we agree with such a mandate for the EBA.

Question 9: Comments are sought on the scope of application as set out above and in particular on the criteria referred to in point 17 for both domestic entities and entities located in another Member State.

We find the scope of application to be reasonable, as long as there is a possibility for waivers. The primary objective is to have compliance with the ratios at group level, as reflected in the proposal from the Basel Committee on Banking Supervision.

Question 10: Should entities other than credit institutions and 730K investment firms be subject to stand-alone liquidity standards? Should other entities be included in the scope of consolidated liquidity requirements of a banking group even if not subject to stand-alone liquidity standards (i.e. financial institutions or 50K or 125K investment firms)?

No.

Question 12: Comments are sought on the different options and in particular for how they would operate for the treatment of intra-group loans and deposits and for intragroup commitments, respectively. Comments are also sought as to whether there should be a difference made between the liquidity coverage and the net stable funding ratio.

We favour a symmetrical treatment of intra-group transactions as suggested in paragraph 23. This method will allow for entities to assume that they can draw on a central pool of liquidity and thus allow for the preservation of certain group-structures.

However, the method will still require the consent of the competent authorities. It is possible that the EBA in the future should be called upon to settle disagreements between supervisory authorities regarding this issue. We believe that maximum harmonization is imperative in this area, as leaving it open for national discretions is harmful to the common market. Otherwise, cross-border capital flows could be restricted and make the supervisory cooperation in times of crisis more difficult.

It is clear that the problem of treatment of transactions between different group entities arises only when one calculates liquidity buffer both at the level of the group and at the level of individual entities. If the calculation was made at the level of the group only, it would be a non-issue.

Question 13: Do stakeholders agree with the conclusion that for credit institutions with significant branches or cross-border services in another Member State, liquidity supervision should be the responsibility of the home Member State, in close collaboration with the host member States? Do you agree that separate liquidity standards at the level of branches could be lifted based on a harmonised standard and uniform reorganisation and winding-up procedures?

Yes, we agree with the proposal.

Question 14: Comments are sought on the merit of using harmonised Monitoring Tools, either in the context of Supervisory Review or as mandatory elements of a supervisory reporting framework for liquidity risk. Comments are also sought on the individual tools listed in Annex III, their quality and possible alternatives or complements.

Yes, we agree with the use of harmonised monitoring tools.

Definition of capital

Benefitting from our experience of earlier banking crises, including the one in Sweden in the 1990s, we stress the importance of high-quality capital which can be used on a going concern basis. Also the recent global crisis indicated the limited value of non-core capital, since the governments decided to rescue banks while they still had positive capital. Hence, capital which would only have been relevant on a gone concern basis could in practice not be called upon to support the resilience of a bank.

Question 16: What are your views on the prudential appropriateness of eliminating the distinction between upper and lower Tier 2, and of eliminating Tier 3 capital?

The Swedish Authorities concur with the Commission services' proposal to terminate the present division of Tier 2 into an "upper" and a "lower" component. We also concur with the Commission services' proposal to terminate the use of Tier 3 capital. Such capital does not fulfil the stated objective criteria.

Question 17: Are the criteria proposed for Core Tier 1, non-Core Tier 1 and Tier 2 sufficiently robust and how might they be improved?

We concur with the Commission services' proposal that capital should be defined by objective criteria rather than by what the capital component is actually called. The criteria proposed in Annex IV of the Commission services' proposal are appropriate and should be strictly implemented, for instance eligible capital must always be paid-in. We are aware that strict implementation will require gradual changes in the capital structure of certain categories of banks, and of banks in certain jurisdictions. However, we believe that this is a price worth paying and the generous grandfathering allowances proposed in the Commission services' proposal will sufficiently reduce the negative side-effects.

In accordance with the above view, the Swedish Authorities support the Commission services' proposal that only common equity should be eligible to be included in Core Tier 1. We believe that the resilience of banks, and also the confidence in banks will benefit from the transparency provided by only allowing such a clearly defined component of capital.

Furthermore, the Swedish Authorities would like to stress the importance of considering market expectations in defining capital instruments. So called "innovative" instruments should be avoided in Tier 1, even in the non-core component. Relevant examples include instruments comprising step-ups or other inducements to early redemption which formally are long-term but where the markets expect the instruments to be redeemed at an earlier stage than their last possible redemption date, and the reputation of the bank may suffer if it does not redeem them early.

The Swedish Authorities concur with Commission services' proposal that the criteria for eligible Core Tier 1 capital for non-joint stock companies such as mutuals, co-operative and savings institutions should be the same as for stock companies although they, obviously, cannot be in the form of common stock. Still ***all*** criteria for stock companies should also be applicable to non-join stock companies.

Question 18: In order to ensure the effective loss absorbency of non-Core Tier 1 capital, would it be appropriate under certain circumstances to require the write down of the principal amount of an instrument or its conversion to a Core Tier 1 instrument? To what extent should the trigger for write-down / conversion be determined objectively or at the discretion of an institution or its supervisor?

In the same vein, the Swedish Authorities support the view expressed in the Commission services' proposal that all non-Core Tier 1 instruments must have a mandatory principal write-down or conversion feature. Furthermore, we are sceptical

to whether ***temporary*** write-downs provide sufficient loss absorption but are willing to support a further investigation of this issue.

Question 19: Which of the prudential adjustments proposed have the greatest impact? What alternative, robust treatments might be considered and what is their prudential rationale?

The most important objective is to improve the loss-absorbing capacity of capital. Thus, in accordance with our above views on Tier 1 versus Tier 2 capital, the Swedish Authorities propose that Tier 1 shall provide the dominating share of overall regulatory capital. In addition, the Swedish Authorities suggest that non-core Tier 1 should only be allowed as a very limited proportion of Tier 1. We wish to await the impact assessment before taking a view on the precise regulatory levels of the capital requirements. In conjunction with the impact calculations, the expected reaction of the financial markets and the investors must be assessed. For instance – will the markets (as they do today) require that a high-rated bank maintains capital well above the (new) regulatory limit also after the proposed strengthening of the capital?

The Swedish Authorities would react positively to any Commission services proposals for proactive measures to be taken by the supervisory authorities before the regulatory thresholds are breached. The cost to the financial system and to the overall economy has proven to be large if a bank, in particular a systemically important bank, fails to meet the regulatory minimum. The framework for taking proactive measures should allow for discretionary decisions on an ad hoc-basis, but should also include provisions that minimize the risk of supervisory forbearance.

Question 20: Are the proposed requirements in respect of calls for non-Core Tier 1 and Tier 2 sufficiently robust? Would it appropriate to apply in the CRD the same requirements to buy-backs as would apply to the call of such instruments? What restrictions on buy-backs should apply in respect of Core Tier 1 instruments?

The same requirements should apply to buy-backs as calls.

Question 21: What are your views on the need for further review of the treatment of unrealised gains? What would be the most appropriate treatment of such gains?

Unrealised gains on debt instruments, loans and receivables should not be included in Tier 1 since they do not fulfil the objective criteria. In addition, the recent global crisis clearly showed that when systemic banking problems arise such unrealised gains will quickly be reversed.

Another type of “unrealised gains” is negative goodwill that is written down and hence increases Tier 1 capital. Goodwill arising for example from the purchase of the net assets of a business that the institution has acquired at a discount could include loans or other instruments eventually measured at fair value. These loans valued at fair value in the acquisition analysis can result in negative goodwill. These types of unrealised gains should also not be included in Tier 1 capital.

Question 22: We would welcome comments on the appropriateness of reviewing the use of going concern Tier-1 capital for large exposures purposes. In this context,

would it be necessary to review the basis of identification of large exposures (10% own funds) and the large exposures limit (25% own funds)?

This issue has to be considered in conjuncture with the debate of the overall level of Tier 1 capital and the equity component of Tier 1. If the prescribed levels of these forms of true capital are sufficiently high, no imminent changes to the present framework are necessary. If, on the other hand, own funds is allowed to include a substantial component of hybrids and Tier 2 capital, we support re-consideration of the approach, and use of Tier 1 capital as basis for calculation of large exposures, instead of the present approach where regulatory capital (encompassing both Tier 1 and Tier 2) serves as a basis.

Question 23: What is your view of the purpose of contingent capital? What forms and triggers would be most appropriate?

The Swedish Authorities view positively the concept of contingent capital, since it could contribute to strengthening loss absorbency on a going concern basis, while providing an alternative to equity instruments both for banks and for investors. Hence, we suggest further investigation of these instruments in order to ensure that it fulfils the objective criteria for high-quality capital, as outlined in the Appendix.

Question 24: How should the grandfathering requirements under CRD II interact with those for the new requirements? To what extent should the grandfathering provisions of CRD II be amended to bring them into line with those of the new capital requirements under CRD IV?

It is important that the full set of grandfathering requirements is transparent and clear for all participants, which will probably require amendments to the requirements of CRD II.

The Swedish Authorities understand that the implementation of CRD IV might take some time. It is therefore important to ensure that the grandfathering rules minimise any regulatory arbitrage in anticipation of the new rules by sending a clear signal that limits as to grandfathering should be imposed on instruments issued now.

Leverage ratio

Complementing a risk-based capital measurement system such as the current Basel II framework by a second system that is intentionally not risk sensitive has to be done with great care so as not to create significant undesirable consequences. This is particularly important where the risk based capital requirements are determined by banks' own internal models as opposed to a system of standardised risk weights. The BIS Central Bank Governors and Heads of Supervision, in their press release from 7 September 2009 reached an agreement on the introduction of "a leverage ratio as a supplementary measure to the Basel II risk-based framework with a view to migrating to a Pillar 1 treatment based on appropriate review and calibration." The Swedish Authorities interpret this as an acknowledgement of the need not only to study the level of the new minimum capital requirement and the timing of the introduction, but also to carefully assess some of the design options. It is also important to consider the effect of all new measures as a package.

Even if the current view, according to the press release above, is that the leverage ratio should eventually become part of Pillar 1, the Swedish Authorities believe that a supplementary measure of this kind would, at least until the effects of the ratio have been properly tested and evaluated, have most of its potential leverage restraining effect as a Pillar 2 tool. It would then act as a common "traffic light" system, providing supervisors with a signal that there may be a case for a Pillar 2 capital add-on, but not imposing this automatically. In any case, given that there would also be Pillar 3 disclosures, a market disciplining effect would also be present.

The Swedish authorities are concerned that an inappropriate leverage ratio might have negative consequences. It is evident that a binding leverage ratio will lead to higher capital requirements for low-risk activities. Swedish banks keep their mortgage assets on their balance sheets. These assets have, historically, been of low risk. Even during the Swedish 1990's crisis the households serviced their mortgages. We would like to stress that the mortgage credit market in Sweden has functioned well for a long time. It is consequently important that a leverage ratio is not designed and calibrated so that it endangers the supply of mortgage credits to Swedish households.

The leverage ratio is intended as a gross measure of exposure. While agreeing with the overall aim of achieving an exposure measure that encompasses as many exposures as possible on a gross basis, the Swedish Authorities would like to stress the importance of considering potential negative effects. Including all repo transactions on a gross basis, and disallowing all netting on derivatives contracts, may have damaging effects on the liquidity provisions in the markets for government paper and other high-quality instruments. The ultimate effect could be to make it harder to hedge liquidity risks and may result in increased funding costs. These effects also risk creating a non-level playing field, given that the reliance on derivatives and securitisations as opposed to cash transactions varies with the size of the market.

Question 25: What should be the objective of a leverage ratio?

The leverage ratio should be seen as a simple, non-risk-based "backstop" supplementary measure to complement the risk-based requirements which will help supervisors to detect cases where financial firms are making inappropriate use of the risk-based capital rules or exploiting loopholes. Under Pillar 2 the supervisor already has the authority to require more capital or reduced risk, but the leverage ratio could be one useful systematic and internationally harmonised tool for achieving such a "back-stop" measure for capital as well as detecting inappropriate behaviour.

Question 26: Which element of going concern capital do you consider would be a more appropriate basis for the leverage ratio? What is you rationale for this view?

Our main concern is to ensure that the capital measure within the leverage ratio does not include any Tier 2 instruments in order to focus on capital which can cover losses on a going concern basis. When limiting this capital measured to going concern capital, we would welcome a definition of this measure which is based on the equity component of Tier 1. In this context it is noteworthy that, in the crisis, market participants focussed on the equity component of Tier 1 capital, rather than the total own funds, or total Tier 1. Also, disclosures of the components of the capital base through Pillar 3 will be important. Of course the choice of capital will have to be

considered in the calibration of any leverage ratio. It is furthermore important to achieve a global harmonisation as a level playing field should be promoted.

Question 27: What is your view on the proposed options for capturing the overall extent of an institution's derivatives business in the denominator of the leverage ratio?

While agreeing with the principle of including all potential exposures on a gross basis, and no netting allowed, the Swedish Authorities acknowledge the need to wait with a final decision until several different measures have been tested and evaluated in the impact study. Simplicity should be a guiding principle. We also strongly underline the need for a global agreement on a common approach.

Question 28: What is your view of the proposed approach to capturing leverage arising from credit derivatives?

The Swedish Authorities support the Commission services' view that "a written credit derivative should be treated in the same way as a guarantee for the purposes of calculating leverage" and using the notional value, as that gives the best economic interpretation of the gross exposure. We also support the notion that netting of credit derivatives exposure should not be permitted regardless of the accounting system used.

Question 29: How could the design of the leverage ratio ensure that it would act as an effective constraint only in benign economic conditions?

In principle, a leverage ratio could be calibrated so that it only becomes a constraint in times of rapid credit expansion and for banks with "excess" leverage. Thus, in the view of the Swedish Authorities, the design of the leverage ratio is closely tied to the calibration.

Question 30: What would be the appropriate calibration of a leverage ratio?

The calibration will be a delicate matter, where information from the on-going quantitative impact study of the BIS, will be useful. The purpose must be that the normal risk-based measure is the primary measure and that a leverage ratio is a complement. Thus, the calibration should result in a meaningful measure that can act as a simple, non-risk-based backstop measure based on gross exposure and therefore be binding for banks with "excess" leverage and in situations of rapid credit expansion while in normal times limiting the number of banks for which the measure is a binding constraint.

Counterparty Credit Risk

The Swedish Authorities agree with the general description of the problems experienced during the crisis and with current regulation. Many of the amendments aimed at resolving these problems include additional requirements on institutions' EPE-models. The Swedish Authorities consider most of the proposed changes justified and relevant. To a large extent they will reduce the shortcomings identified in the EPE-models. But taken all together, these additional requirements may reduce incentives for institutions to move to more advanced risk measurement techniques. The fundamental principle behind Basel II regulation was to give institutions

incentives to use better risk measurement techniques and improve their risk control. According to the Swedish Authorities, simultaneously introducing these new requirements may possibly blur this fundamental principle. The total effect of the measures and subsequent effects on the incentives of institutions to move to more advanced measurement approaches should be taken into consideration before the amendments are introduced. In Sweden, currently no bank is using an EPE-model.

Question 31: Views are sought on the suggested approach regarding the improved measurement or revised metric to better address counterparty credit risk. With respect to suggestion to incorporate - as an interim measure - a simple capital add on by means of calculating the loan-equivalent CVA charge, views are sought on the implications of using VaR models for these purposes instead.

We would like the Commission services to further investigate the impact of the interim solution, to use a bond equivalent as a proxy for credit valuation adjustments, as suggested under (1-b). Primarily, we do not agree with the conclusion that institutions will be able to use their current measurement systems. Institutions will have to invest money in system development which will probably be quite costly. That investment may be lost within a few years when the interim method is replaced by a better and more permanent method and the proposal may therefore be too costly in relation to the benefits of finding an interim solution.

As regards to the proposal to introduce a ***qualitative*** requirement for highly leveraged counterparties, the proposal is too vague and must be explained further before an assessment can be made of its appropriateness.

Question 33: Views are sought on the suggested approach regarding the multiplier for the asset value correlation for large financial institutions, and in particular on the appropriate level of the proposed multiplier and the respective asset size threshold. In addition, comments are sought on the appropriate definitions for regulated and unregulated financial intermediaries.

Swedish Authorities support the suggested approach, but have currently no clear view about the appropriate level of the multiplier or the asset size threshold.

Question 34: Views are sought on the suggested approach regarding collateralised counterparties and margin period of risk. Views are particularly sought on the appropriate level of the new haircuts to be applied to repo-style transactions of (eligible) securitisations. In this context, what types of securitisation positions can, in your view, be treated as eligible collateral for purposes of the calculation of the regulatory requirements? Any qualitative and/or quantitative evidence supporting your arguments would be greatly appreciated.

Swedish Authorities support the proposals. Regarding the proposal under (iii-a) to increase the margin period of risk for large, illiquid or hard-to be replaced trades, Swedish Authorities consider that some effort should be made to define the terms, especially, “illiquid”. Otherwise there is a risk that institutions and supervisors will interpret this requirement very differently.

Question 35: Views are sought on the suggested approach regarding central counterparties and on the appropriate level of the risk weights to be applied to collateral and mark to market exposures to CCPs (on the assumptions that the CCP is run to defined strict standards) and to exposures arising from guarantee fund contributions.

Swedish Authorities welcomes enhanced standards for CCPs and support using them as the basis for determining which CCPs should attract a zero risk weight. This will also contribute to harmonised regulation of CCPs. The Swedish authorities also agree that it is important to give institutions incentives to use CCPs for OTC derivatives. To reinforce incentives there has to be higher capital requirements for contracts not cleared through a CCP. The efforts described here to reinforce counterparty risk management requirements will also serve as an incentive to clear transactions through a CCP because they will increase the cost of bilateral clearing relative to CCP clearing. Moreover, we find it natural that also foreign exchange contracts are cleared through CCPs, thereby reducing the settlement risk.

Question 36: Views are sought on the risk management elements that should be addressed in the strong standards for CCPs to be used for regulatory capital purposes discussed above. Furthermore stakeholders are invited to express their views whether the respective strong standards for CCPs to be used for regulatory capital purposes should be the same as the enhanced CPSS-IOSCO standards.

The Swedish Authorities strongly support using the enhanced CPSS-IOSCO standards for regulatory capital purposes. OTC derivatives are traded in a global market by contributing to the development of strong global standards and by supporting their use; supervisors contribute to smoothly functioning markets and sound capital treatment of banks' exposures. While the risk management elements mentioned here appear suitable, the Swedish Authorities do not recommend that supervisors set ex ante requirements for the standards but instead support cooperation between supervisors and the CPSS-IOSCO standards setters through an iterative dialogue as the best way to reach robust standards.

Question 37: Views are sought on the suggested approach regarding enhanced counterparty credit risk management requirements. Do the above proposed changes to the counterparty credit risk framework (in general, i.e. not only related to stress testing and backtesting) address fully the observed weaknesses in the area of risk measurement and management of the counterparty credit risk exposures (both bilateral and exposures to CCPs)?

The Swedish Authorities support the new model validation standards.

The following issue would benefit from further clarification: According to paragraph 123 the proposal would also ***"add a new operational requirement for EPE models for institutions to have an independent risk control unit responsible for the design and implementation of the institution´s CCR management system"***. In this regard, we would like to question if there really are material differences between the new rules about risk control/management in Annex IX and the old rules in CRD, Annex III, part 6, p. 17.

Countercyclical measures

The working document presents valuable solutions on how to solve the problem of procyclicality. We agree that these models should be further analyzed and evaluated. In our opinion it is, however, important to see these proposed models as a contribution in the debate regarding procyclicality and not as a final solution to the problem.

We support a global framework for capital buffers. At the same time, it is important to highlight the need to ensure that the regulation of the financial sector is balanced in such a way that it neither obstructs granting of credits to creditworthy customers, nor initiates the building up of risk and thereby threatening financial stability. The Swedish Authorities also want to express their support for global harmonisation of accounting rules and find it important that the EU continues to support the IASB's work and the harmonisation of accounting standards

Question 40: Do you agree with the proposed dual structure of the capital buffers? In particular, we would welcome your views on the effectiveness of the conservation buffer and the counter-cyclical buffer, separately and taken together, in terms of enhancing the resilience of banking sector going into economic downturn and ensuring the flow of bank credit to the "real economy" throughout economic cycle.

Yes, a dual structure for capital buffers, to be applied in parallel with through-the-cycle provisioning for expected losses and the leverage ratio will provide sufficient tools throughout the economic cycle.

Question 41: Which elements should be subject to distribution restrictions for both elements of the proposed capital buffers and why?

We agree with the elements proposed in paragraph 160.

Question 42: What is the appropriate timing – following the breach of capital buffer targets – for the restriction to capital distributions to start? Should the time limits for reaching capital buffer targets be determined by supervisors on a case-by-case basis or harmonised across EU?

The buffers should be determined on a case by case basis.

Question 43: What is the most suitable macro variable (or group of variables) that may be used in the counter-cyclical buffer to measure the dynamics of macro-level risks pertinent to the banking sector activities?

The Swedish Authorities support the idea of introducing regulation for capital buffers in the CRD. We also favour harmonisation in order to promote both simplicity and a level playing field. Still, countries differ in several aspects and finding an identical variable that is equally appropriate in all countries may be difficult. For instance, a certain economic variable may be defined differently in different countries. Also, deviations from the trend of credits relative to GDP may be a useful indicator, but not necessarily for all countries and all situations. Thus some form of adaptation to national circumstances may be warranted. The ESRB could possibly play a role to ensure consistency across countries in this regard.

Question 44: What are the relative merits and drawbacks of capital buffers versus through-the-cycle provisioning for expected losses with respect to minimising procyclical effects of current EU banking regulation?

We find the proposal to reduce procyclicality through the regulatory capital framework a solution which has the potential to create the "cushions" that credit institutions may need in severe economic downturns without reducing the transparency of the financial statements. Through-the-cycle provisioning for expected future losses ensures the build-up of provisions in good times.

If a dual system, with both dynamic provisioning and capital buffers, is introduced, we believe that it is of great importance that the total effect of the methods is considered when deciding the appropriate level for the buffers. The additional capital buffer could also be used as a Pillar 2 measure.

Question 45: Do you consider that it would be too early to fully assess the cyclicality of the minimum capital requirement?

Yes, the Swedish Authorities find it too early to fully assess the cyclicality of the minimum capital requirements. The fairly recent introduction of the IRB approach and the significant roll out of portfolios into IRB that has taken place since the IRB-authorisations were given makes it difficult to find long time series of comparable data. This, in combination with the difficulty to define "cyclicality of capital requirements" makes up the basis for our view.

Systemically Important Financial Institutions

The Swedish Authorities consider the issue of the Systemically Important Financial Institutions (SIFIs) to be of high importance. Weaknesses in SIFIs played a major role in exacerbating the problems during the global crisis, e.g. by deleveraging with negative impact on several markets, by contagion or by being "too-big-to-fail" or, even, in some cases "too-big-to-be-rescued". It is our view that some "economic externalities" of SIFIs are not fully taken into consideration by the institutions themselves and thus must be addressed through regulation and supervision.

Question 46: What is your view of the most appropriate means of measuring and addressing systemic importance?

The approach to measuring and addressing systemic importance must take into account the emergence, concentration and transmission of systemic risk and it must do this in a dynamic and forward looking manner. The degree to which a firm contributes to systemic risk may change and a binary scale will be unable to capture the different degrees of systemic importance. The Swedish Authorities believe that while the size of an institution is an important indicator it does not fully reflect the systemic importance of an institution. There may for example be differences between markets and institutions in the degree to which assets are securitized or held off-balance sheet. As a result of these variations it is possible to see differences in the size of banks' balance sheets which do not reflect their degree of systemic importance. Interconnectedness, complexity, activities, and group structure must all be taken into account in a comprehensive approach.

The package of measures to be used to address systemic importance should include: heightened supervision and stricter requirements on risk management and internal control systems; stricter corporate governance requirements; assessment of compensation practices to curb excessive short-termism and risk taking; strong incentives and controls to support the use of central counterparties to clear derivatives transactions; crisis management and credible resolution measures (ensuring that national authorities have adequate tools for addressing ailing banks without necessarily resorting to public support), recovery and resolution plans and additional Pillar 2 capital or liquidity requirements where warranted, based on clear guidance / standards for the supervisory assessment.

The Swedish Authorities want to stress the importance of the EU single market and that any rules on SIFIs do not hamper the functioning of the single market.

The Swedish authorities are also supportive of introducing national but harmonised ex ante stability fees within Europe. This could help address the issue of systemically important banks and the "too big to fail" problem in the future. There are several advantages with introducing ex ante stability fees. First and most importantly, such a fee makes the financial sector contribute to the cost of maintaining financial stability and ensures that the cost is not borne by the tax-payers. Secondly, an ex ante stability fee forces the banks to in advance internalise the cost of their risk taking and not just compensate for it ex post. This reduces moral hazard and therefore the probability and expected magnitude of a crisis. A risk-weighted stability fee strengthens these incentives further. Moreover, having ex ante paid-in fees will facilitate the crucial political decision-making in the event of a financial crisis. Tax-payers will know that money paid by the banks constitutes the first line of defence and this will increase their acceptance for support measures. Furthermore, an ex ante stability fee will not add new burdens to the banking sector after a crisis when the economy is weak and does not in that sense add to procyclicality. Also importantly, compared with a Tobin-type tax, a stability fee can be implemented without broad global coverage. Unlike the Tobin tax it does not hurt liquidity in the financial markets and it is directly aimed at the risk on the balance sheet of the banks. The stability fee can be adjusted to country-specific needs and circumstances.

Also unlike the Tobin tax it does not hurt liquidity in the financial markets and it is directly aimed at the risk on the balance sheet of the banks. The stability fee can be adjusted to country-specific needs and circumstances.

Question 47: How could the Commission services ensure a consistent prudential treatment of systemic importance across financial sectors and markets?

While the approach to systemic risk should be dynamic and flexible it should also be consistent between EU member states. To ensure a consistent prudential treatment of systemic importance it is necessary that the approach developed includes all systemically important institutions, products and infrastructures of the financial sector. The prudential system must prevent that risks migrate to less regulated and supervised entities and instruments.

An important component is the development of a sound regional and global framework for effective crisis management that enables the orderly resolution of cross-border financial institutions, including, but not limited to, SIFIs is necessary.

The Commission services should also consider further proposals that would ensure that the financial sector pays for the negative externalities it generates, e.g. through risk based ex ante privately financed crisis-management fees (as further developed in our answer to the previous question).

Single rule book in banking

Question 48: In which areas are more stringent general requirements needed given national or other circumstances? Is Pillar 2 a sufficient tool to address specific negative circumstances at credit institutions and if not, how could it be strengthened?

The Swedish Authorities are generally positive to moving to maximum harmonisation. A single rule book will contribute further to the achievement of the internal market. Moreover, since it is likely to improve communication and collaboration across jurisdictions, it would also be beneficial from a financial stability perspective.

We have not identified areas where more stringent general capital requirements are needed in Sweden. If areas for stringent rules are identified through objective criteria, we agree that they can be included in the single rule book, but not if they are subject to discretion. Such adjustments should be left to Pillar 2.

As regards Pillar 2, we believe that it is a sufficient tool to address specific negative circumstances in individual institutions. Proliferation of different national approaches at Pillar 2 would at the same time need to be contained in order not to jeopardize harmonisation. We therefore believe that it may be useful with technical standards from the EBA on Pillar 2, provided that they leave room for sufficient supervisory discretion.

Question 49: What is your view of the suggested prudential treatment for exposures secured by mortgages on residential property outlined above? What indicators and their respective values do you consider appropriate as possible preconditions for the application of the preferential treatment of exposures secured by mortgages on residential property?

The Swedish Authorities generally support efforts to adjust the legislative framework taking into account the experiences from the current crisis and from different countries.

While real estate prices normally have played an important role in many financial crises, and also residential real estate prices in some countries in this crisis, there is little evidence so far that ordinary residential mortgages granted by responsible lenders have played any major part in this crisis in Sweden. The low risk weight for residential property lending is supported in Sweden when looking at the data that include both this financial crisis and the banking crisis in Sweden in the 1990's. For IRB banks, the capital requirement for residential mortgages is about one percent of the exposure, depending on the bank.

However, the Commission services' document is silent on the point that the proposed changes are not directly applicable on credit institutions applying the IRB-approach. The latter have the largest market share in mortgage lending and the measures would therefore probably have limited effect on the market. Instead it would introduce an

extra layer of regulatory requirements which will distort competition between credit institutions using the standardised approach and those using an IRB approach. The Swedish Authorities believe that before a hard test is introduced we must be convinced that competition is not distorted and that it will be effective, which is not the case for this proposal.

Question 50: What is your view of the suggested prudential treatment for exposures secured by mortgages on commercial real estate outlined above? What indicators and their respective values do you consider appropriate as possible preconditions for the application of the preferential treatment of exposures secured by mortgages on commercial real estate? In particular, are additional preconditions needed to ensure the soundness of this treatment? Do you believe that the existing preferential risk weight applied to exposures secured by mortgages on commercial real estate should be increased?

For much the same reasons, we are not in favour of the proposal regarding the preferential treatment of commercial property. In a report from July 2009 concerning banks' lending for commercial real estate in Sweden, Finansinspektionen finds that compared with the banking crisis in the beginning of the 1990s, banks now stress the importance of a underlying cash flows in real estate companies, and banks have considerable internal valuation expertise which reduces the risk of overly optimistic valuations. We believe that continuing such focus is more important than regulation of LTV-levels for preferential treatment.

Question 51: Should the prudential treatment for exposures secured by mortgages on residential property be different from the prudential treatment for exposures secured by mortgages on commercial real estate? If so, in which areas and why?

There may be objective differences – e.g. price volatility or the actual degree of defaults – between the markets that warrant different prudential treatment, but the problems with these proposals, just as in question 49 and 50, is that "different treatment" as a concept is only applicable to the standardised approach, and not to IRB. In general, the standardised approach should be conservative enough to give the banks incentives to move to IRB, but in Sweden this is already the case.

Question 52: What is your view of the merits of introducing measures that would help to address real lending throughout the economic cycle? Which measures could be used for such purposes? What is your view about the effectiveness of the possible measures outlined above?

Reducing the risk of asset bubbles clearly is an important challenge and property markets are key in that respect. However, in order to preserve transparency in the risk-based framework, it would be more appropriate to address this issue in Section V exploring countercyclical measures or in the macro prudential framework underway, in particular as the proposals would not all affect IRB-banks. In addition, authorities are always able to use Pillar 2 in discussions with banks on all components of banks' credit portfolio.

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