Finansinspektionen
Box 7821
103 97 Stockholm

SVERIGES RIKSBANK
SE-103 37 Stockholm
(Brunkebergstorg 11)

Tel +46 8 787 00 00
Fax +46 8 21 05 31
registratorn@riksbank.se
www.riksbank.se

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Consultation response on Pillar 2 capital requirements regarding maturity assumptions and Finansinspektionen's supervision of the banks' calculations of risk weights for corporate exposures

The Riksbank welcomes Finansinspektionen's proposal to improve the banks' use of internal models for calculating risk weights and that Finansinspektionen is introducing new capital requirements under Pillar 2.

Extensive work is currently being done internationally on remedying several of the deficiencies identified in the banks' internal models and their regulation. The Riksbank is pleased that Finansinspektionen is developing the requirements regarding Swedish banks' internal models for calculating the capital requirement for credit risk pending the introduction of new international regulations. It is important that Finansinspektionen ensures as far as possible that the banks' internal models reflect the banks' actual risks and make sufficient demands with regard to capital. This work should be done in the light of the changes currently being discussed by the Basel Committee.

The Riksbank welcomes Finansinspektionen's proposal to introduce a maturity floor and to sharpen the demands regarding banks' PD estimates

The Riksbank welcomes Finansinspektionen's proposal to introduce a maturity floor. It is important that this is done pending the introduction of the new international agreements regarding the banks' internal methods.

When the major Swedish banks calculate capital requirements for their corporate exposures they need to take into account the time to maturity of these exposures. In general, the shorter time to maturity a loan has, the lower the capital requirements are.[1] As the banks have obtained approval for the use of internal models, the average maturities used by the banks in calculating capital requirements have declined for some exposures. At the same time, it is difficult to see that the maturities have in practice become shorter. The Riksbank shares Finansinspektionen's assessment that there is a danger of underestimating the risk arising from these exposures and that the banks' capital requirements will therefore be too low.

[1] See "International Convergence of Capital Measurement and Capital Standards", http://www.bis.org/publ/bcbs128.pdf

The Riksbank also welcomes the proposal to tighten the requirements regarding the way the banks estimate the probability of default for various exposures (PD estimate).

Banks that use internal models need to produce PD estimates as part of their calculation of risk-weighted assets. When making this estimate, the banks generally use historical observations of default frequencies to establish their final estimates. To ensure that these estimates do not underestimate the actual risk present, it is important that the historical observations on which the estimate is based contain sufficient time periods of financial stress.

The Riksbank shares Finansinspektionen's view that the percentage of so-called downturns on which the calculation of PD estimates, and thereby risk weights, is currently based, underestimates the actual risks.

As Finansinspektionen points out, the current PD estimates are based on a long period of time during which the Swedish economy has developed relatively well and growth has been relatively higher than in many other countries. If this period is given too much scope as a base for the banks' PD estimates, there is a risk that the banks will underestimate the size of the potential losses in a poorer economic situation. This can in turn have negative consequences for both financial stability and the real economy.

Further doubts regarding the banks' internal models

A necessary condition for the banks to have sufficient resilience to manage periods of financial stress is that they have sufficient equity. The banks' capital levels and the requirements made of them are thus extremely important for financial stability and economic developments in general.

The major Swedish banks' capital ratios, that is, their equity in relation to the risk-weighted assets they hold, have increased significantly in recent years.[2] This development has been largely driven by a fall in the banks' risk weights rather than by an increase in their equity. Although part of the downturn in risk weights can probably be explained by lower risks, a large part of the decline is due to the banks now using other models to estimate the risks in their loan portfolios.[3] Finansinspektionen estimated that the major banks' average risk weights declined from 47 per cent to 23 per cent between 2006 and 2013. Around 20 percentage points of this decline was due to the banks changing the way they determine risk weights. Furthermore, Finansinspektionen estimated that only a small part of the decline in risk weights was due to a decline in actual risk in the banks' operations.

On a global level, some concern has also arisen in recent years among many policymakers and market participants regarding the banks' internal models and whether they underestimate the risks stemming from the banks' exposures. Underestimating the risks can lead to risk weights and capital requirements becoming too low from an overall economic perspective.

[2] See "Capital requirements for the major Swedish banks – the Riksbank's view", memorandum to the Financial Stability Council's meeting in June 2015, Sveriges Riksbank.
[3] See Risks in the Financial System, December 2014, Finansinspektionen.

The weaknesses stated include that the banks lack sufficient relevant data on historical losses. In many cases the banks do not have data from a sufficiently long time period, which increases the uncertainty regarding the accuracy of the models. A further problem with using historical data is that it does not necessarily give a good prediction of future events. Moreover, internal models are generally complex and the regulations at times leave scope for different interpretations. Both the Basel Committee and some banking organisations have pointed out that this gives rise to major difference between the banks' internal methods. It can mean that identical exposures are given different risk weights and capital requirements, depending on which bank's method is applied. A further weakness of the models is that they focus too much on the risks in an individual bank and therefore do not capture structural vulnerabilities and risks that may exist in the banking system as a whole.[4] There are therefore a number of difficulties in trying to measure risk in the banks' operations in a satisfactory manner. The banks also have an incentive to reduce their risk weights, since this gives a lower capital requirement.

The Basel Committee is currently working on remedying several of the deficiencies identified in the banks' internal models.[5] This includes a proposal that to completely abolish the use of internal models for certain types of exposure. Furthermore, they propose extensive changes and restrictions to many of the parameters used as a base for the internal calculations of risk-weighted assets. These measures are intended to reduce the undesirable variation in risk-weighted assets sometimes noted among banks with international operations and which undermines confidence in the banks' capital adequacy.[6]

The work on revising the framework for internal models need to continue

The exact effects of Finansinspektionen's proposed measures on the banks' risk-weighted assets and capital requirements are not described in the consultation documents.

The introduction of a maturity floor for the major banks' corporate exposures will lead to an increase in the banks' CET 1 capital requirement of 0.2-0.6 per cent of risk-weighted assets, depending on the bank in point, according to Finansinspektionen's calculations.

Furthermore, the major Swedish banks' average risk weights for corporate exposures after Finansinspektionen's proposed method for PD estimates are slightly above 30 per cent, which is much lower than the average risk weight for corporate exposures of around 60 per cent in the euro area.[7] The Riksbank sees the proposed changes as a welcome step in improving the regulatory framework for using internal models to calculate capital adequacy requirements. The Basel Committee's current work on reviewing international regulations with regard to banks' internal models will further contribute to greater confidence in the capital adequacy regulations and in the resilience of the banking system.

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[4] For a review of the weaknesses in the banks' internal models, see "Capital requirements for the major Swedish banks – the Riksbank's view", memorandum to the Financial Stability Council's meeting in June 2015, Sveriges Riksbank.
[5] See, for instance, "Consultative Document Reducing variation in credit risk-weighted assets – constraints on the use of internal model approaches", http://www.bis.org/bcbs/publ/d362.pdf
[6] See "Analysis of risk-weighted assets for credit risk in the banking book", http://www.bis.org/publ/bcbs256.pdf
[7] See Consultation memorandum: FI's supervision of banks' calculations of risk weights for exposures to corporates, 2016, Finansinspektionen.

On behalf of the Executive Board:

Stefan Ingves

Kerstin Haglund

Taking part in the decision: Stefan Ingves (Chairman), Kerstin af Jochnick, Martin Flodén, Per Jansson, Henry Ohlsson and Cecilia Skingsley.

The report was presented by Tomas Edlund