Headline Rather than Reality: Proposed Changes to Capital Requirements for Swedish Mortgages

The Swedish regulator (FSA) is proposing, as of 31 December 2018, to apply a hard Pillar 1 requirement for Swedish residential mortgages under the provisions of Article 458 of the Capital Requirements Regulation (CRR). This allows a competent home supervisory authority to apply risk-weighting measures relating to assessed systemic or macro-prudential risks.

The Pillar 1 requirement will replace the current arrangement. At present the FSA imposes, through Pillar 2 guidance, a risk-weight floor of 25% for Swedish mortgages. This applies on a consolidated basis to Swedish banks using the IRB approach to calculate residential mortgage exposures.

In this report Scope comments on the implications of the proposal. We examine the potential effects on the 'real' solvency of the banks in light of the expected reduction in capital requirements and reported total capital ratios, expressed as a percentage of risk-weighted assets (RWAs). We also examine the anticipated reduction in reported CET1 ratios, which may affect investor perceptions of Swedish banks' Additional Tier 1 (AT1) securities. Finally we consider the implications for Nordea after it has moved its headquarters to Finland.

Motivation for the proposed changes

The decision by Nordea (Issuer Rating AA-, stable outlook) to re-domicile its headquarters to Finland in October 2018 is driving the proposed change, according to the FSA. Nordea's retail and commercial banking activities in Sweden will be conducted through branches of the new Finnish bank (albeit the Swedish mortgage subsidiary, Nordea Hypotek, remains). Regulation of Nordea will be conducted under the rules of the European Banking Union, with the ECB in conjunction with Finnish supervisors primarily responsible for setting overall capital requirements.

As a consequence, the Swedish FSA will lose the amount of direct influence it holds at present over large parts of Nordea's operations, and the overall setting of its capital requirements. The FSA is concerned that the change could lead to a situation where different players in the Swedish mortgage market face different capital requirements for their Swedish mortgage exposures, leading to competitive distortion.

Effects of the change on capital requirements

The new proposal is calibrated such that total capital requirements will remain neutral in absolute terms. Thus, the banks will not be asked to hold additional capital but will also not be expected to reduce current nominal capital.

However, when expressed as a percentage of risk-weighted assets (RWAs), the metric that most investors focus on – total capital requirements – will decrease. The headline impact (with 4Q17 as the baseline) will be between 1.7% (for Nordea) and 9.1% (for Swedbank), as detailed in **Figure 1**.

The decline in the total capital requirements will occur because the denominator in the capital ratio -- i.e. the risk exposure amount (REA) -- will rise as a result of an effective increase in risk weights on Swedish residential mortgages. Historically this has been captured via Pillar 2, but now a risk weight floor will be applied through Pillar 1 instead.

Analysts

Jennifer Ray
j.ray@scoperatings.com

Pauline Lambert
p.lambert@scoperatings.com

Associate

Hannes Merlecker
h.merlecker@scoperatings.com

Related Research

Nordea's Move to Finland: Comments on Changing Capital Requirements
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Scope Ratings GmbH

Suite 301
2 Angel Square
London EC1V 1NY

Phone +44 203-457 0 4444

Headquarters

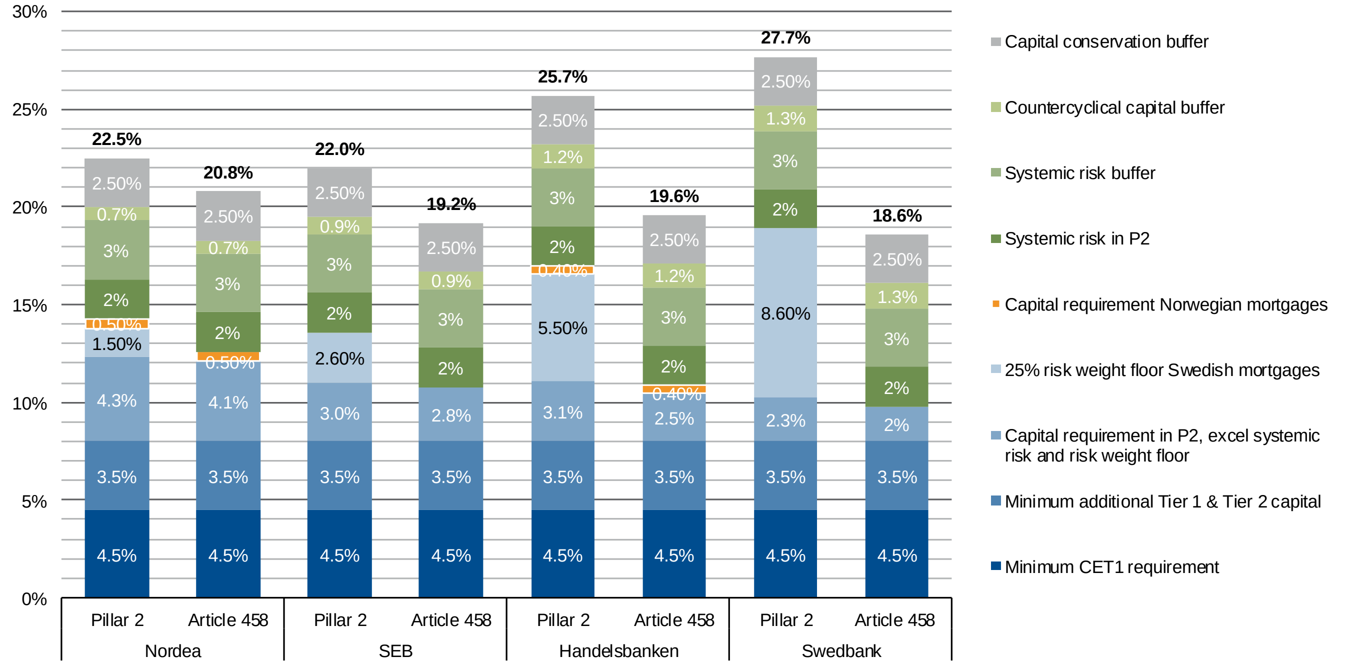
Lennéstraße 5
10785 Berlin

Phone +49 30 27891 0
Fax +49 30 27891 100

info@scoperatings.com
www.scoperatings.com

Bloomberg: SCOP

Figure 1: Impact on the total capital requirement (% of risk-weighted assets) based on 4Q17 numbers

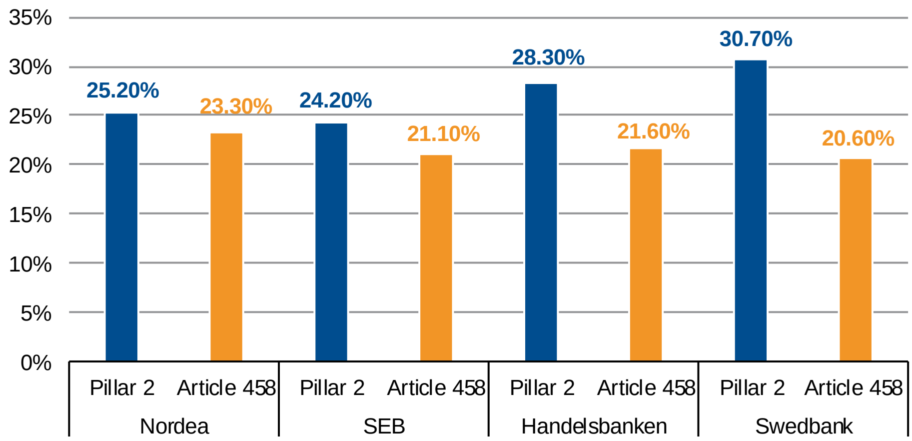


Source: Finansinspektionen, Scope Ratings

Effect of changes on reported capital ratios

Reported total capital ratios will be reduced due to the above-mentioned increase in REA. The fall is estimated to be least for Nordea (1.9%) and greatest for Swedbank (10.1%), as detailed in **Figure 2.** In reality, the anticipated fall in reported total capital ratios is a technical effect and does not imply an overall weakening of Swedish banks' solvency positions – although, as explained below, the fall in reported capital ratios may affect market perceptions of the banks' AT1 securities.

Figure 2: Impact on the total reported capital ratio (% of risk-weighted assets) based on 4Q17 numbers



Source: Finansinspektionen, Scope Ratings

Impact on Additional Tier 1 (AT1) Securities and Restrictions on Distributions

With the inflation in the REA, reported capital ratios may no longer exceed those of most European peers by such a noticeable margin. Further, we would also expect reported CET1 ratios to fall. As a result, the current ample headroom to the Maximum Distributable Amount (MDA) threshold, at which automatic dividend restrictions apply, should also decline. In Sweden the current Pillar 2 add-on is not considered a hard requirement but is rather “strict guidance”. As such, it does not currently affect Swedish banks’ MDA calculations.

Scope will continue to monitor developments. Given that we already discount the higher headline capital ratios of Swedish banks in our rating analysis of their AT1 securities, we see no immediate rating implications. Scope rates the AT1 securities of Swedbank (at BB, on review for potential upgrade), Svenska Handelsbanken (at BB+, on review for potential upgrade) and Nordea (at BBB-, with a stable outlook).

Reciprocity and the Nordic Countries’ Memorandum of Understanding

The FSA expects that the new requirements may affect branches of non-Swedish banks with exposures to Swedish mortgages. In this regard, we believe it is referring to the Memorandum of Understanding (MOU) between supervisors in Sweden, Norway, Denmark and Finland, which relates to prudential supervision of significant branches. This was enacted on 2 December 2016.

The MOU aims to increase collaboration between banking supervisors in relation to the sum of significant branches in a host country which would, if they were subsidiaries, be considered systemically important. It is based on a reciprocal approach and participants agree to take a risk-based view of branch supervision in each jurisdiction, which is intensified if the branches have systemic importance. The MOU makes specific reference to the requirements under Article 458 as being in principle subject to reciprocity.

In this light, we note that there is precedence for reciprocity with Finland. The Swedish FSA has agreed to apply a similar measure regarding risk weights on residential mortgages in Finland, also under Article 458. This was implemented with effect from 1 January 2018 (thus appearing for the first time in 1Q18 reports), and consists of a credit institution-specific minimum level of 15% for residential mortgage loans.

As an aside, while the FSA in Norway has introduced Pillar 1 risk-weight floors for mortgage exposures of Norwegian banks, these have not been implemented using Article 458. Instead of implementing these measures through Pillar 1 requirements, Swedish banks with exposures to Norwegian mortgages hold capital under Pillar 2 to match the increase.

In reality, we expect that the main impact of reciprocal measures could be on the capital requirements imposed on Nordea in Finland, assuming Sweden’s proposal is adopted reciprocally by Finnish regulators/the ECB. Banks from other Nordic countries have less than 10% of the Swedish mortgage market. Within this, among major names, Danske Bank (issuer rating A+, stable outlook) has the most exposure, albeit smaller than that of the large Swedish banks. Swedish residential mortgage exposure at DnB (issuer rating AA-, stable outlook) is minimal.

Possible implications for Nordea’s capital requirements

The Swedish FSA has modelled the effects of the proposed changes to include Nordea in its calculations. However, the FSA does not expect these plans to become concrete until

31 December 2018, by which time Nordea is already expected to have completed its re-domiciling to Helsinki.

Nordea says that it expects that its formal capital requirements will be addressed as part of the formal Supervisory Review and Evaluation Process (SREP) for 2018, and that the requirements imposed during the 2017 SREP will apply until then. The bank does not expect to be given ‘new’ capital requirements by the ECB until the 2018 SREP process is completed. If the proposal is passed and Finland reciprocally adopts it, depending on the timing, it could apply to Nordea at any time after the beginning of 2019.

Some equity analysts have anticipated a possible release of equity by Nordea after its re-domiciling. Scope does not consider this as the most likely scenario, as Nordea has stated that it is strategically important for the bank to maintain a capital position consistent with issuer ratings in the AA category. Implementation of the FSA’s proposal to cover Nordea’s future Swedish branches of the Finnish bank would make such an equity release less likely, in Scope’s view.

Scope Ratings GmbH

Headquarters Berlin

Lennéstraße 5
D-10785 Berlin

Phone +49 30 27891 0

Frankfurt am Main

Neue Mainzer Straße 66-68
D-60311 Frankfurt am Main

Phone +49 69 66 77 389-0

Paris

33 rue La Fayette
F-75009 Paris

Phone +33 1 82 88 55 57

London

Suite 301
2 Angel Square
London EC1V 1NY

Phone +44 203-457 0 4444

Madrid

Paseo de la Castellana 95
Edificio Torre Europa
E-28046 Madrid

Phone +34 914 186 973

Milan

Via Paleocapa 7
IT-20121 Milan

Phone +39 02 30315 814

Oslo

Haakon VII's gate 6
N-0161 Oslo

Phone +47 21 62 31 42

info@scoperatings.com
www.scoperatings.com