Swedish Bank Capital Requirements: New Proposals From Swedish Finansinspektionen

On March 1, Finansinspektionen (FI) published two consultation memos relating to capital requirements calculation. In particular, the proposed changes will increase corporate risk weighted assets (RWAs) for portfolios under the IRB approach as well as raise the Pillar 2 guidance for extra capital due to a stricter approach to loan maturity. Scope believes that if the proposals were to be implemented, they could marginally strenghten banks' credit fundamentals through higher earnings retention.

The first of the two memoranda relates to the actual calculation of RWAs. There has been concern, amongst some market observers, including ourselves, about the marked decline in RWA intensity at Swedish banks in recent years. In particular, FI believes that the banks' assumptions with respect to downturn periods are not sufficiently prudent, and proposes to push banks to assume higher long term default levels.

More specifically for corporate risk weights, the proposals entail (i) that at least one of every five years be considered a downturn year and hence that a downturn PD be used in the calculations; also (ii) that the default frequency in a downturn be raised.

While it is too early to draw conclusions about the impact of the proposed measures, FI expects these to increase risk weights for corporate exposures under the IRB approach while making average risk weights more stable over time. The measures should also reduce dispersion among banks. Finally, FI indicates that it expects all banks to have a corporate risk weight in excess of 30%. If implemented, we believe that the proposal may reduce capital ratios and erode the buffer over the total CET1 guidance for rated banks Swedbank (A-, stable), Handelsbanken (A, stable) and Nordea (A+, stable). Depending on the final implementation, some banks may end up below the total CET1 guidance, including Pillar 2. However, we believe that the strong organic profitability provides the three banks enough flexibility to comply with the increased requirements, for example by adjusting their dividend policy as needed.

The second memorandum deals with the issue of underestimatation of economic maturity of loans. Pillar 1 RWA calculations for credit risk take into consideration the contractual maturity of loans. In other words, credit risk increases with a commitment's maturity (almost linearly). However, the RWA formulas are based on contractual maturities, which may underestimate the actual credit risk, and particularly so in a downturn. In fact, while in theory banks could decide not to renew lending when it comes due, in practice this could not be the preferred course of action, as it could in some cases push viable borrowers over the edge, increasing the default rate. For this reason, the FI proposal includes an additional capital charge, to be implemented through Pillar 2. This would be calculated by introducing a maturity floor of two and a half years and calculating the capital charge corresponding to the increased RWAs for corporate portfolios under the IRB approach. The Pillar 2 CET1 add-on is estimated by FI to range between 0.2% and 0.6%.

We view positively these proposals. While in the short term they should have a negative impact on reported capital ratios, we believe that they will increase stability over the longer term. We expect that the main impact of the proposals would be to boost bank's balance sheets via earnings retention, which is positive from a credit risk perspective.

Analysts

Marco Troiano, CFA
m.troiano@scoperatings.com

Related Research

Swedish capital requirements: tough for a reason
September 2015

Swedish property market poses risks to banks' fundamentals
January 2015

Scope Ratings AG

Suite 407
2 Angel Square
London EC1V 1NY

Phone +44 20 3457 0444

Headquarters

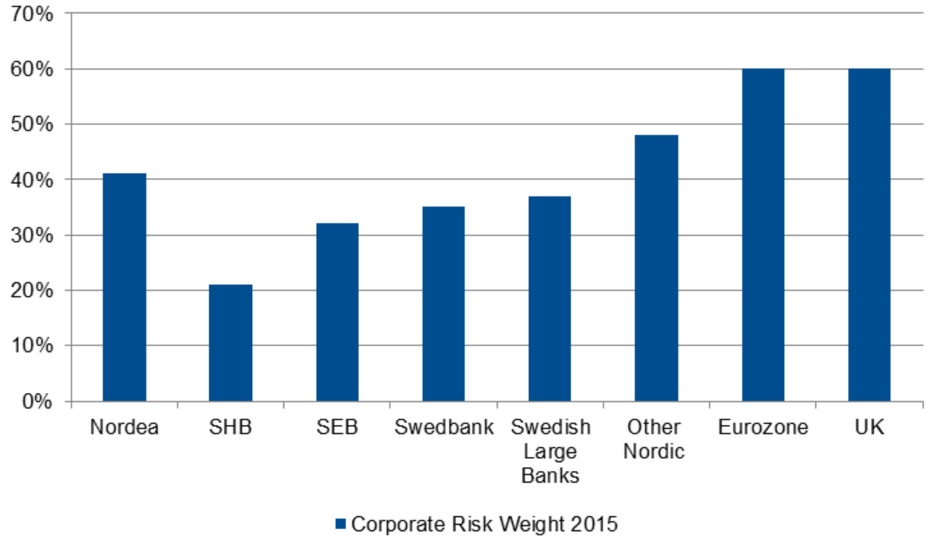
Lennéstraße 5
10785 Berlin

Phone +49 30 27891 0
Fax +49 30 27891 100
Service +49 30 27891 300

info@scoperatings.com
www.scoperatings.com

Bloomberg: SCOP

Figure 1:Average risk weights for corporate loan exposures



Source: Finansinspektionen, Scope Ratings

Scope Ratings AG

Headquarters Berlin
Lennéstraße 5
D-10785 Berlin

Phone +49 30 27891 0

Frankfurt am Main
Rüsterstraße 1
D-60325 Frankfurt

Phone +49 69 97944 754

Paris
21, Boulevard Haussmann
F-75009 Paris

Phone +33 1 53 43 29 89

London
Suite 407
2 Angel Square
London EC1V 1NY

Phone +44 20 3457 0444

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

Phone +34 914 186 973

info@scoperatings.com
www.scoperatings.com

Disclaimer