Capital floors: the design of a framework based on standardised approaches

Introduction
The main focus in this response is on the combined effect of the consultations on a new standardised approach for credit risk and new capital floors. Therefore, in the summary we comment on the combined effects of the proposals. Thereafter we comment on the proposal for new capital floors. For detailed comments on the proposal for a new standardised approach for credit risk we refer to our response on that consultation.

Summary
The Swedish Bankers’ Association strongly oppose the introduction of permanent capital floors. It is our opinion that permanent capital floors are not necessary, they will rather be detrimental to than enforcing financial stability. The reason is that risk-based capital requirements provide incentives for banks to assess and price risk correctly, while binding capital floors will give banks the wrong kind of incentives, for example to replace low risk assets with high risk assets.

Instead, it is our firm view that the use of the internal ratings-based approach should be maintained. We believe that banks that use internal rating based methods have better knowledge and control of their risk. Capital floors that are designed and calibrated incorrectly can become the binding requirement for many banks, and not the backstop they should be.

If new capital floors are to be introduced, they should at least not be developed and put into force until all other new capital requirements (including for example TLAC/MREL) have been implemented and the effects of them have been analysed.

Looking at the proposal for a new standardised approach for credit risk as a stand-alone proposal (i.e. not as a reference point for disclosure of IRB risk weights and new capital floors) we can’t see any urgent need for change in the current standardised approach. Most banks that use the standardised approach are small or
medium-sized and focus on retail lending. For these banks the proposal will add a lot of complexity and compliance costs, without necessary strengthening the risk sensitivity or measurement and control of risk.

If the proposed standardised approach for credit risk is to be introduced we believe that it is essential to leave room for national flexibility and calibration. We strongly oppose a one-size-fits-all model that uses the same risk drivers and the same calibration for banks all over the world.

Finally, it is not reasonable that the Basel Committee agrees on regulatory changes that will have huge impact on both banks and their customers in many jurisdictions, without a very thorough analysis and involvement from national authorities. The analysis must not only focus on risk weights and capital requirements, but also on how established business models for banks may change and how the customers of the banks will be affected.

**General comments**

*The proposed capital floors will be a game changer for Swedish banks*

We strongly recommend that a risk-based approach also in the future will be the basis for determining capital requirements for large banks. Risk-based capital requirements give banks incentives to manage their risks and capital in a way that assures that bank lending is directed to those parts of the economy where it provides most benefit and is priced adequately with respect to the risk of loss.

Banks that use the internal ratings-based (IRB) approach generally have better knowledge of and control over their risk. Our view is that this knowledge and control ultimately will increase the stability of the financial system. Therefore, the regulatory framework should continue to give incentives to use internal methods to calculate capital requirements.

Generally speaking, the Basel Committee’s proposal of new capital floors, based on the standardised approaches, will hit high quality IRB portfolios disproportionally. For the major Swedish banks this kind of new floors are likely to become the binding capital requirement, given current credit portfolios and a calibration of the floor in line with the current transitional Basel 1 floor.

Capital floors based on the proposed standardised approach will typically not reflect a bank’s risk according to its balance sheet, business model and the markets it operates in. It will present the bank as if its business model is one of a “standardised bank” and as if it operates in different markets than it actually does. The idea that capital requirements based on a standardised model will increase comparability is
simply flawed. If there are differences in the actual risk in two portfolios belonging to the same exposure class – which is often the case\(^1\) – a capital requirement that at least in some way reflects that actual risk will provide for better comparability than a capital requirement that doesn’t capture the risk at all. Risk-based capital requirements, using banks’ internal approaches, will thus cater for better comparability between banks for investors who care about the capital adequacy of banks and the risk that the bank will not sustain unexpected losses.

As we understand, it is the Basel Committee’s intention that the new permanent capital floor should, in contrast to the current EU legislation, become an integral part when defining a banks risk exposure amount and thereby have a direct impact on the minimum and the buffer capital requirements. This means that the new floor, if calibrated in line with the current transitional Basel 1 floor, will create far higher capital requirements in EU than the current floor does. This must be taken into account when calibrating the new framework. Otherwise the consequence is likely to be that today’s risk-based capital methods will be more or less eliminated in Sweden and replaced by, in principle, the new standardised approach for all IRB banks. The capital requirement calculated from these rough standards will by far overestimate the need of capital as assessed in the various stress tests recently performed by the Swedish FSA, the EBA and the Riksbank, and also internally by Swedish banks. A comparison with historical credit losses on the Swedish market further confirm this assessment.\(^2\)

The oversizing of the capital requirements will be further exaggerated if MREL and TLAC-requirements are applied on a risk exposure amount that has been enhanced due to the new capital floors.

The Swedish authorities have chosen to implement Basel 3 early, without the transitional implementation of the requirements, with the clear ambition to have higher capital requirements than the minimum requirements. This has mainly been done through adding requirements and buffers in Pillar 1 and Pillar 2, rather than by introducing capital floors for different kinds of exposures (with the exemption of risk weight floors for residential mortgage added in Pillar 2). In general, the highly scrutinised IRB models used by the Swedish banks are the basis for capital requirements which means that there is a clear distinction in the requirements between low risk assets and high risk assets. Apart from the fact that this provides for the right incentives for banks to assess and price risk correctly, it also means that large buffers are created above the minimum criteria for capital. Having large buffers in the banks means that there are ample room and time for reacting to a deterioration in capitalisation, before all the capital is consumed and before a

\(^1\) See for instance the differences in non-performing residential mortgage loans in Appendix 1. The difference between countries has been significant even in situations of deep economic stress.

\(^2\) Appendix 2 shows the loan losses for mortgage lending in Sweden in the period 1987 to 2014.
potential point of non-viability is reached, and the bank needs to be resolved. This is valuable both for the bank and for the society, and limits the risk of a need for public intervention and/or public support to the banking system.

Capital floors calculated on the basis of the now proposed standardised approach will in rough terms double the risk weighted amount for Swedish IRB banks. They will thereby also double the minimum capital requirements to a level that is deemed to be far above what is needed to manage the shocks assumed in the stress tests performed in the recent years. This would necessitate a complete change in the current regulatory and supervisory framework, and will remove both risk sensitivity and flexibility from the framework. This would in turn be detrimental for the risk management in banks and give rise to cost for society resulting from a cruder pricing of risk, as well as deteriorating capabilities when it comes to the potential to manage problems in banks.

**Potential consequences for Swedish banks and their customers**

A removal of risk-based capital requirements for Swedish banks will create incentives for the banks to change their current behaviour. In particular the banks will get strong incentives to increase margins on their, from a credit risk perspective, best exposures and to securitise such exposures. This in turn is likely to result in smaller balance sheets in banks and more credit intermediation taking place outside the regulated banking sector. Significant volumes of covered bonds are likely to be replaced by asset backed securities, which will result in a far less resilient credit intermediation process than the current very stable Swedish banking model. Households and corporates will have to pay higher interest rates which will counteract the ambition to boost growth and create new jobs.

A higher portion of the society’s credit risk exposure being held by non-banks is likely to make the credit intermediation process less resilient in turbulent times, since non-banks may not have the same commitment to provide financing as the regulated banks have.

Given that a lot of economies globally are still struggling with getting back to normalised conditions for economic growth, and central bank policy is still extremely expansionary from an historic perspective, a further increase of capital requirements is very poorly timed, especially one that mainly strikes against lending to the real economy. Private investments are badly needed, especially since they are not burdening the already stressed fiscal situation of many countries. A new capital floor may in many jurisdictions lead to significant increases in the capital requirements for corporate exposures, which in turn would lead to severely deteriorating conditions for the intermediation of credit through banks to the private sector. This is an argument

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3 See example in Appendix 3
in itself not to rush into another increase in capital requirements for this particular sector, until conditions have normalised. In this context, it is also important to underline that long implementation periods does not really help, as banks because of market pressure often will need to adjust to new rules as soon as they are known.

It is not, against this background, reasonable that the Basel Committee agrees on regulatory changes that will have a large impact on both banks and their customers in many jurisdictions, without a very thorough analysis, in which national authorities are involved, not only of risk weights and capital requirements but also on how established business models for banks may change and how the customers will be affected.

One important conclusion is therefore that the timeline of the process has to be extended significantly to allow a wider discussion about the proposals merits and shortcomings and make a thorough assessment of the impact not only for banks but for the society as a whole.

*Capital floors will introduce a new, unnecessary layer of complexity*

After the financial crisis the capital requirement framework has expanded. It now consists of strict Pillar 1 requirements, several capital buffers (capital conservation buffer, countercyclical buffer, G-SII/O-SII buffers (EU) and systemic risk buffer (EU)), Pillar 2 requirements and leverage ratio. The framework will soon also be complemented by TLAC/MREL requirements. Furthermore, in the EU we have a new powerful supervisory authority in the form of ECB that will probably have large effect on both the supervision and the regulation of banks in Europe.

The large number of different capital requirements gives regulators a lot of possibilities to demand the level of capital that they believe is necessary, both for separate banks and for the total banking sector. The lesson learnt so far is that the framework has been used in quite different ways in different jurisdictions, even within the European Union. From a banking perspective the large number of regulatory tools and the different applications creates uncertainty and high compliance costs.

To introduce an additional layer of complexity in the form of a new standardised approach for credit risk and new capital floors is in our view neither necessary nor useful. On the contrary, we believe that new floors can be counterproductive to the purpose described by the Basel Committee, especially if they are introduced before the other parts of the capital framework have been introduced and the effects have been analysed.

Since the Basel proposal in itself have very significant consequences both for SA banks and IRB banks, and also for their customers, we can see a large risk for
unintended effects if the Basel Committee continues with the proposal before the total effects of new regulations are well understood and analysed.

We believe that reforming the internal ratings-based approach, and maintain a risk-based and internal models based approach, is a far more fruitful method to achieve the objectives of the Basel Committee than the proposed new capital floors. The European Banking Authority has suggested a number of measures to make sure that the internal risk-based approaches are implemented in a similar way across jurisdictions and banks within Europe. In our view, this is a much more useful and less destructive way of achieving the goals of increased comparability that the Basel Committee wants to achieve through the capital floors.

Specific comments
To be able to have a concrete view of the design of the capital floor (including the level of aggregation) it is necessary to have information on the final shape and calibration of the standardised approach for credit risk, the result of the quantitative impact study and the level of the floor. Therefore, it is our firm view that the final design of a possible floor must be discussed in further consultations from the Basel Committee.

SWEDISH BANKERS’ ASSOCIATION

Johan Hansing       Maria Nilsson

Figure 3.8. Nonperforming Residential Mortgage Loans
(In percent of total residential mortgage loans outstanding)

Sources: Federal Reserve Bank of New York; Reserve Bank of Australia; Bank of Spain; U.K., Council of Mortgage Lenders; and Lea (2010b).
Note: Nonperforming loans that are more than 90 days in arrears. For Australia, Canada, and the U.S., banks only.

Source: Swedish Bankers' Association
Appendix 3. Effects for lending to the corporate sector in Sweden

To illustrate the negative effects of the proposed floors for the Swedish economy, in particular the effects for the corporate sector, the following quantitative effects can be estimated.

The four large Swedish banks (that stands for approximately 70% of corporate lending and 60% of corporate credit intermediation incl. bond markets in Sweden) have an average risk weight for corporate exposures of 36%. The average risk weight may seem low, but there are a couple of important factors behind that.

Firstly, around 40% of Swedish corporate lending consists of funding for residential property, partly loans to housing associations, partly loans to companies funding multi-family houses. The way to own an apartment in Sweden is to own a share in a housing association. The shares in a housing association work in practice as if you own an apartment, you can use the share as collateral for a mortgage and it is possible to buy and sell it just as an owned apartment. The funding of the apartment building is typically done through the individuals mortgaging the shares, but the housing associations can also take on some debt, for instance for renovation projects. The cost of those loans is then part of the monthly fee that the owners of the shares pay to the housing associations. Loans to housing associations make up for around 20% of Swedish corporate lending. The risk in lending to the housing association is obviously very low, since the outstanding loans typically are very small compared to the value of the property and since the housing association have the possibility to adjust its payment capacity through debiting the owners of the shares for the cost of lending. The banks have been able to prove in the internal models approach that lending to housing associations have very low risk. The credit losses were low both in the stress of 2008 and 2009 and in the very severe banking crisis of the 1990’s.

In Sweden, rental apartment buildings are to a high degree owned by municipality owned companies, who normally fund part of the buildings through mortgages in banks. The leverage is typically low, below 50%. Due to rent regulation, cash flows from the rental contracts are extremely stable. The rental regulation also leads to very stable cash flows for the privately owned part of the rental market. This has also lead to low losses for multi-family housing credits, which are reflected in the IRB calculated risk weights for the banks.

Another important part of corporate lending in Sweden is lending to large internationally diversified companies, often in the export industry, that typically also has a low leverage and stable cash flow. These companies are very important for the Swedish export driven economy. The larger companies are also dependent on a much more granular SME sector, consisting of subcontractors to the export industry.

Given the structure of the corporate sector, and the way that the risk factors are chosen in the proposed standardized approach, it is unlikely that the corporate sector would get an average risk weight that is very different from the 100% level. Some larger companies may benefit from lower risk weights, but some of the residential companies would probably get a higher risk weight than that, especially because of the fact that national accounting standards means that property values are recognised at purchase price less accumulated depreciations, meaning that a lot of these companies would look artificially levered, when the property values in the accounts often will be only a fraction of the market value.
Assuming a new floor at 80%, this would mean that capital requirements would more than double for the corporate sector (from the average risk weight of 36% to an average of roughly 80%). As a lot of developed economies, Sweden is in deep need of increased investments, in order to be able to sustain reasonable economic growth in the long run. The central bank is at present exploring options to increase the supply of credit and to increase demand. Investments are important not the least within the sectors that will be worst hit by the rise in capital requirements. Furthermore, one reason for residential property to be highly valued in Sweden is that new construction has been low for a long time, and that Swedish property owners typically keep the value of the properties through ambitious and continuous renovation programmes. It is important that borrowed capital does not become much more expensive for those projects. The export sector that typically leads Swedish growth is also highly dependent on continuous investments in machinery and production equipment.

To double the capital requirements for corporates, which in turn will significantly increase interest rates, seems from this background to be extremely counterproductive, especially since capital requirements have already increased significantly after the financial crisis. This increase looks even more awkward when taking into account the fact that the Swedish banks have proven to be one of the most prudent banking sectors throughout the financial sector, showing very low losses for the domestic exposures even in the crisis of 2008-2009, when GDP in Sweden fell by 5%.