Notification template for measures to be taken under Article 458 of the Capital Requirements Regulation (CRR)

Template for notifying the European Central Bank (ECB), the European Systemic Risk Board (ESRB) and the European Commission of stricter national measures pursuant to Article 458(2) CRR and for requesting the ESRB to issue a recommendation to other Member States to reciprocate the measures pursuant to Article 458(8) CRR

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- macropru.notifications@ecb.europa.eu when notifying the ECB (under Article 5 of the Single Supervisory Mechanism Regulation (SSMR)[1]);
- DARWIN/ASTRA when notifying the ESRB;
- FISMA-E-3-NOTIFICATIONS@ec.europa.eu when notifying the European Commission.

The ESRB will forward this notification to the European Parliament, the European Council and the European Banking Authority (EBA) without delay. This notification will be made public by the ESRB after the relevant authorities have adopted and published the notified macroprudential measure[2].

E-mailing/uploading this template to the above addresses constitutes official notification; no further official letter is required. To facilitate the work of the notified authorities, please submit the notification template in a format that allows the information to be read electronically.

1. Notifying national authority and scope of the notification	
1.1 Name of the notifying authority	Finansinspektionen, Swedish Financial Supervisory Authority.
1.2 Country of the notifying authority	Sweden.
1.3 Categorisation of the measure	Finansinspektionen, in its capacity as the designated authority for the purpose of Article 458 of Regulation (EU) No 575/2013, intends to implement a national measure regarding risk weights for targeting asset bubbles in the residential property and commercial immovable property sector (Article 458(2)(d)(iv) of Regulation (EU) NO 575/2013). The proposed measure is a risk weight floor of 35% for certain corporate exposures secured by commercial properties and a risk weight floor of 25% for certain corporate exposures secured by residential properties. The requirement is applicable to credit institutions that use the Internal Ratings Based (IRB) approach for calculating regulatory capital requirements and aims to deal with the systemic risks that are linked to the overheated real estate market in Sweden.

[1] Council Regulation (EU) No 1024/2013 of 15 October 2013 conferring specific tasks on the European Central Bank concerning policies relating to the prudential supervision of credit institutions (OJ L 287, 29.10.2013, p. 63).
[2] On request by the notifying authority, it may be agreed with the Head of the ESRB Secretariat that this notification, or a part thereof, should not be published for reasons of confidentiality or financial stability.

	For the purpose of this notification, the term “bank” has the same meaning as “credit institution” as defined in Article 4 of the CRR.
1.4 Request to extend the period of application of an existing measure for up to two additional years **(Article 458(9) CRR)**	Not applicable.
1.5 Notification of a measure to which Article 458(10) CRR applies (‘notification only procedure’)	Not applicable.
2. Description of the measure	
2.1 Draft national measure **(Article 458(2)(d) CRR)**	The proposed measure for Swedish corporate exposures secured by commercial or residential properties constitutes an important element of the capital requirements for Swedish banks. The measure is sought to tackle the elevated systemic risks connected to the real estate sector in Sweden. The measure increases the stability of the Swedish financial sector as credit institutions would be required to hold own funds proportionate to the risks in the Swedish commercial real estate sector. The measure is intended to target properties that are owned to generate income through rental to tenants. It targets exposures in the exposure class corporate and can be both exposures secured by commercial and residential properties. In this notification corporate exposures secured by commercial or residential properties are also called commercial real estate (CRE) exposures. The proposed measure refers to the exposure-weighted average risk weights. It is calculated by dividing the portfolio´s risk exposure amount[3] (REA) by the exposure amount (EAD). The additional risk exposure amount according to Article 458 equals: • for corporate exposures secured by commercial properties (properties physically located in Sweden for rent in commercial purposes to generate a rental income. For example, offices, stores, warehouses, industries and hotel properties): EAD*MAX[(35%-current RW);0] • for corporate exposures secured by residential properties (apartment buildings physically located in Sweden for rent in commercial purpose to generate rental income, where the number

[3] Before applying the so-called SME supporting factor according to article 501 of the CRR.

	of residences in the property exceeds three): EAD*MAX[(25%-current RW);0] The measure constitutes average risk weight floors applied at the portfolio level of the concerned IRB banks covered by the measure. It affects the total risk exposure amount (TREA) and, therefore, the minimum Pillar 1 requirements that IRB banks have to meet at all times according to Article 92 of the CRR. The measure thus increases the overall REA of the affected IRB banks compared to a baseline without this measure in place. According to chapter 1, section 4, second paragraph of the Special Supervision of Credit Institutions and Investment Firms Act (2014:968), Finansinspektionen is the authority in charge of the application of Article 458 of the CRR. The measure concerns Article 458 (2)(d)(iv) of the CRR.
2.2 Scope of the measure **(Article 458(2)(d) CRR)**	The measure applies to: • exposures in Sweden collateralised by commercial and residential immovable properties within the exposure class corporate according to article 147 (2) (c) of the CRR The measure is applicable to banks authorised in Sweden that use the Internal Ratings Based (IRB) approach for calculating regulatory capital requirements. The measure applies to IRB banks as their model-implied risk weights are relatively low, compared to those implied by the standardised approach. These are also typically the credit institutions with the largest share of CRE exposures in their portfolio in Sweden. The measure complements the existing 458 measure in Sweden that targets mortgages and that is expected to be prolonged. The following properties are not covered: 1) agricultural properties 2) properties owned directly by municipalities, states and regions 3) properties where more than 50 percent of the property is used for own business (not rental) 4) multi-dwelling properties where the purpose of the property is not commercial (for example housing associations that are owned by the residents and that are not profit making) or where the number of dwellings is less than four. In cases where an exposure is counted as multiple collateral, only the part of the exposure that concerns the financing of real estate for commercial purposes shall be included. The measure applies on an individual and consolidated basis. The commercial real estate sector is generally defined by FI as properties that are owned to generate income through rental to tenants. The credit risk for lending to property owners depends on what type of properties the lending concern, as different type of properties are more or less vulnerable to disturbances of different kinds. FI assess that properties for rental can mean larger financial risks for the property owners and their financiers than

	properties for other purposes such as premises for own operations or private residences. Properties used for offices, retail and industry are for example often more sensitive to a recession than community or residential properties where rental income and rental rates tend to be more stable over time. Community properties often have long rental contracts and tenants with high credit worthiness (state, regional or local governments). Also renting to residential real estate is in general stable. The tenants are households that need a residence and who rarely stops paying rent even at loss of income or increased costs. Further, the mobility on the housing rental market is relatively low. Office, retail and industry properties implies a larger financial risk, as the tenants generally are businesses. For those tenants both the demand for premises and the ability to pay rent is affected by the financial performance of the business. As the performance development of the business generally is connected to the macroeconomic development, revenues and vacancies in these types of properties are depending on the economy at large.
2.3 Calibration of the measure	The calibrated levels of the proposed measure are: • 35% for corporate exposures secured by commercial properties, and • 25% for corporate exposures secured by residential properties. The capital requirement, in nominal terms, corresponding to the risk weights floors of 35% and 25%, respectively, is expected to be SEK 18 billion at the consolidated level (data from Q4 2022) or 4% of the total capital requirement for the largest Swedish banks[4]. The measure increases the risk weights on Swedish CRE exposures, from 17% (volume-weighted) to 35% for commercial properties and from 13% to 25% for residential properties. Thus, the risk weight floors increase the capital levels and create an added loss-absorbing capacity in the affected banks. The choice of risk weights is in line with the analyses previously conducted by FI, even if the results are associated with some uncertainty.[5] FI makes the assessment that the additional capital requirement ensures that the banks have enough capital to cover the risks in their lending to commercial real estate sector. The proposed risk weights are differentiated to take into account the difference in the financial risks between commercial housing properties (corporate exposures secured by residential real estate) and other commercial real estate. For comparison, it can be mentioned that the risk weight floor on mortgages in Sweden is set to 25 percent, as a national measure according to article 458 of the CRR. And FI deem that the commercial real estate sector poses a greater risk to financial stability than the risks with household mortgages.

[4] Capital requirements for the Swedish banks, fourth quarter 2022

[5] See Commercial Real Estate Market and Financial Stability, May 2019, FI, Stability in the Financial System, May 2019, FI, and Stability in the Financial System November 2019, FI.

2.4 Suitability, effectiveness and proportionality of the measure **(Article 458(2)(e) CRR)**	<u>Suitable</u> The proposed measure aims to increase resilience in the financial system in relation to the systemic risk that is connected to the CRE sector in Sweden. The CRE sector in Sweden is highly indebted and banks' exposure to the sector is large. Many CRE firms are vulnerable to shocks or a deterioration in the macroeconomic conditions. Major problems in the CRE sector could give rise to credit losses for banks. The measure ensures that banks hold enough capital to cover the loss risk for corporate exposures secured by commercial and residential properties. This makes them more resilient to potential economic downturns and ensures that they maintain the supply of credit to the real economy. The measure also ensures a level-playing field as article 458 of the CRR contains provisions where the activating country can request reciprocity by other EU member states. Reciprocity will make sure that the measure also applies to foreign branches and direct foreign exposures. The measure is also suitable as it can handle a situation with varying risk weights that comes with the gradual implementation of changed internal models following the IRB review. ESRB emphasise, in their recommendation on vulnerabilities in the EEA commercial real estate sector, that relevant authorities should continue to ensure that risks and vulnerabilities related to the sector are adequately addressed.[6] They recommend activating appropriate capital-based measures deemed necessary to mitigate risks to financial stability stemming from the sector where the CRE-related exposures are material. In addition, as mentioned in the ESRB report on vulnerabilities in the EEA commercial real estate sector[7], risk weight measures are suitable in cases where banks' risk weights are varying[8] or continuously declining. <u>Effective</u> The measure is effective as it targets banks' exposures that are linked to the systemic risks in the CRE sector. The exposures being corporate exposures secured by commercial and residential real estate. The measure is also effective considered the possibility for reciprocation. <u>Proportionate</u> The calibration of the proposed measure is proportionate considering the identified risks related to the Swedish CRE sector as it increases resilience without imposing a burden that is excessive in relation to the purpose of the measure. It is also proportionate considering which institutions that are affected. The design of the measure has a very good precision in targeting IRB banks' exposure to the commercial real estate sector.

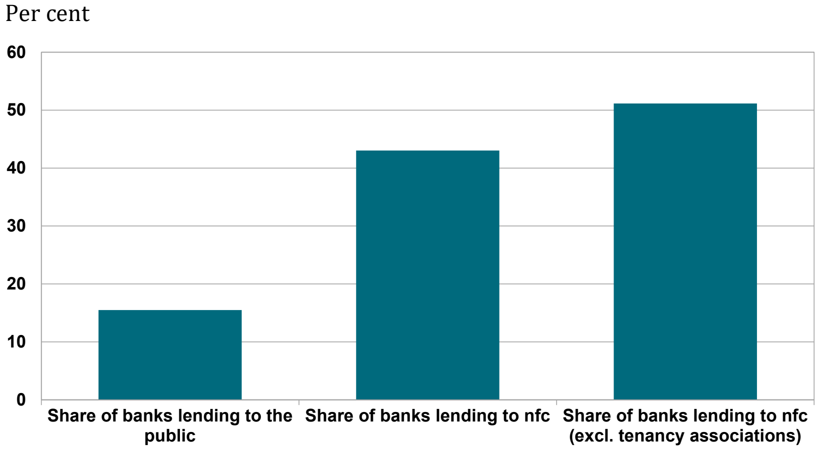
[6] Recommendation on vulnerabilities in the EEA commercial real estate sector

[7] Vulnerabilities in the EEA commercial real estate sector

[8] Risk weights for the largest banks in Sweden vary between 14.6 to 19.4 percent for commercial real estate and between 10.2 to 17.9 for residential real estate as per Q1 2022.

	The capital requirement for the measure will constitute around 4 percent of total capital requirements for the largest banks in Sweden and increase resilience without unduly affecting the supply of credit to CRE firms. If the measure is reciprocated the impact on affected banks from other jurisdictions, based on our information, are presently considered to be small as their current risk weights are higher or close to the proposed floors. **In summary**, FI's view is that introducing risk weight floors for exposures secured by commercial real estate in accordance with article 458 in CRR is suitable, effective and proportionate. Following the elevated systemic risks in the Swedish CRE sector, the measure is necessary to ensure that banks have enough capital to withstand any potential disruptions in the CRE sector that could otherwise affect banks financial position and the real economy in general.
2.5 Other relevant information	In 2020, FI introduced institution specific Pillar 2 requirements for IRB-banks due to underestimation of risk in the models used for commercial and residential real estate exposures. The capital add on correspond to a 35 percent average risk weight for all corporate exposures secured by commercial real estate in Sweden and a 25 percent average risk weight for all corporate exposures secured by residential real estate in Sweden. Currently, the banks' internal models are under review. The review follows the EBA roadmap set out to handle concerns about undue variability of own funds requirements for credit risk stemming from the application of internal models. The review includes, among other, new guidelines that will clarify and harmonize the requirements for internal models. Banks have, as a result, identified a need for changes in their models and has applied for essential model changes for almost all their credit risk models. The review is complex, and a relatively large part of applications has not met the required standards and have been withdrawn to be revised by the banks. This process takes time, and the models will be implemented gradually. The review is a prioritized area at FI and the review of the initial applications is estimated to continue during the first half of 2023. At present it is too early to assess an end time for the review or what the review will exactly lead to in terms of level of risk weights for CRE exposures. The gradual implementation of new models leads to practical difficulties when using a Pillar 2 capital add on. This add on is calculated yearly through the comprehensive Supervisory Review and Evaluation Process (SREP) and updates to SREP decisions are resource demanding and time consuming. Also, the internal models are not designed to tackle systemic risk. However, the resilience that the current risk weight floor contributes to remains important for the financial system given the high level of systemic risks related to commercial real estate. The measure should therefore be introduced as a Pillar 1 requirement through article 458 in CRR instead of as a capital add-on via Pillar 2. Article 458 is, in addition, straight forward in design when it comes to reciprocity which is important as the risks applies also to foreign institutions. Hence, the additional impact on total capital requirements due to the proposed measure under article 458 will be limited since the measure will

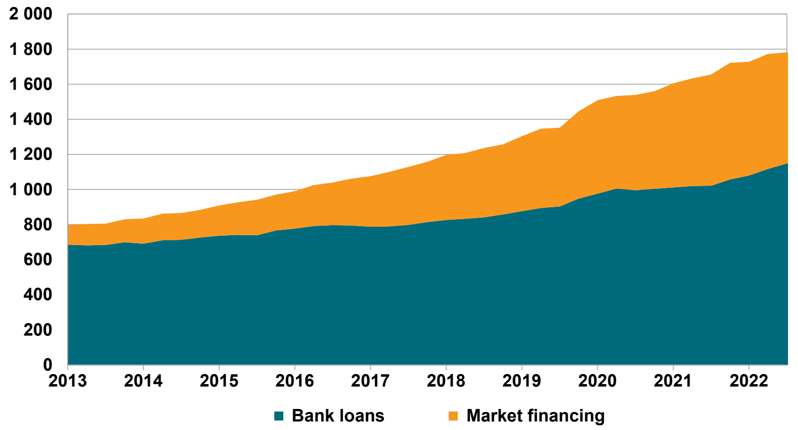
	replace a corresponding capital requirement in Pillar 2. The new measure will rather maintain the current level. The proposed measure is not expected to affect banks' interest margins or the supply of credit to CRE firms because the capital requirements on domestic banks will remain largely unchanged after replacing the P2R with the risk weight measure. The current capital add-ons in Pillar 2 that was introduced in 2020 was evaluated in 2022. The evaluation showed that the additional capital requirements had limited effect (0.12 percentage points) on banks' interest margins on loans to commercial real estate firms. Further, the evaluation showed no signs of banks taking greater risks in order to maintain profitability (a concern when the add-ons were introduced). Lending to CRE firms has continued to grow since 2020 and there are no signs of changes in the banks' credit supply to CRE firms. The evaluation also shows no signs of changes in CRE firms demand for credit. However, also other factors affect banks' lending to CRE firms, and the effect of the additional capital add-ons in P2 is difficult to fully disentangle.
3. Timing for the measure	
3.1 Timing for the decision on the measure	12/09/2023
3.2 Timing for publication	13/09/2023
3.3 Disclosure	The decision on the implementation of the measure will be published on Finansinspektionen's website. This will include justification for the measure.
3.4 Timing for application (Article 458(4) CRR)	30/09/2023
3.5 Duration of the measure **(Article 458(4) CRR)**	The measure is proposed to enter into force on 30 September 2023 and apply for two years, or until the macroprudential or systemic risk ceases to exist. Finansinspektionen will consider deactivation of the measure if the risks cease to exist.
3.6 Review **(Article 458(9) CRR)**	Finansinspektionen will continue to monitor the measure regularly based on its overall macroprudential (mitigating) impact on the observed systemic risks in the Swedish commercial real estate sector and take actions if required. The necessity and appropriateness of the measure will be reviewed in line with the requirements in Article 458 of the CRR, with the possible amendments of the measure implemented as soon as possible after identification.

4. Reason for the activation of the stricter national measure	
4.1 Description of the macroprudential or systemic risk in the financial system **(Article 458(2)(a) CRR)**	**The Swedish commercial real estate (CRE) sector is important for financial stability because of the sector's size and because it is closely interconnected with both the financial system and the real economy.** **FI has** together with other national and international organisations (such as the Riksbank, the ESRB and the IMF) **highlighted the commercial real estate sector as one of the biggest vulnerabilities for financial stability in Sweden.** Overall, the CRE-related risks are elevated in Sweden. The reason for this is that for a long time there have been large CRE price rises in parallel with increased indebtedness. The sector is large and closely connected to both the real economy and the financial system. The sector is important for many financial market participants, such as investment funds, insurance companies, pension funds and credit institutions. Historically, the commercial real estate sector, both in Sweden and in other countries, has played a significant role in major financial crises. The Swedish banking sector has large exposures to the commercial real estate sector, and CRE firms constitute the banks' largest group of borrowers among non-financial corporates (NFC). Roughly 50 percent of the bank's loans to NFC (excluding tenant associations) goes to CRE firms (Diagram 1). CRE firms have also increased their debts the most of all companies in Sweden in recent years. 1. Bank lending to CRE firms  Source: FI Note. The first bar shows the share of bank lending to CRE firms in relation to the public (i.e. lending to households, non-financial corporations and the public sector), the second bar is the share of bank lending to CRE firms in relation to all non-financial corporates (nfc), the third bar is the corresponding share in relation to nfc excluding tenant associations from nfc. "Banks" refers to Danske Bank, Handelsbanken, Länsförsäkringar bank, Nordea, SBAB, SEB and Swedbank in Q1 2022. **Although bank loans are still the largest source of financing for most CRE firms, borrowing via the capital market has become increasingly important.** Between 2012 and 2022, financing via the capital market increased from around 10 to 35 percent of the listed CRE firm loans (Diagram 2). This has led to different capital investors, such as funds in Sweden and abroad, as well as insurance and pension companies, becoming more exposed to the Swedish CRE sector. This development means that the CRE sector is now more interconnected with the real and financial sector

compared to before. Any disturbances can therefore more easily spread to and within the financial system.

2. CRE firms' market financing and bank loans

SEK billion

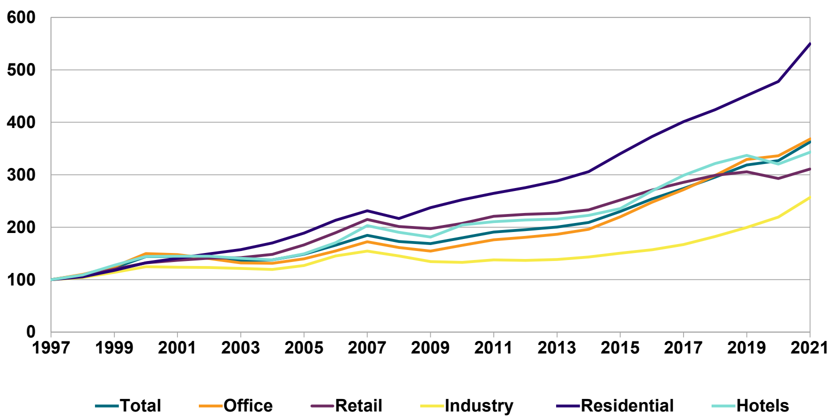


Source: FI and the Riksbank.
Note. The data covers the period up to and including the fourth quarter of 2022.

For a long period, **the Swedish economy has been in a unique situation with very low interest rates and high economic growth**. This has benefited the CRE firms, which have had good earnings and low financing costs. This development has driven up property prices significantly (Diagram 3), which has enabled CRE firms to borrow more and more to finance property acquisitions and project investments. Because the market values have increased more than the liabilities, the loan-to-value ratios have decreased and are relatively low (Diagram 4). But CRE firms' debts are large, especially in relation to the companies' earnings and cash flow (Diagram 5). Moreover, the debts of many CRE firms are adjusted to a very low interest rate at the moment, which means that many may run into problems when interest rates rise, and the economy declines. **Large debts make CRE firms sensitive to disturbances such as changed financing conditions or a worsened economic situation.**

3. Rising CRE prices

Index 1997 = 100

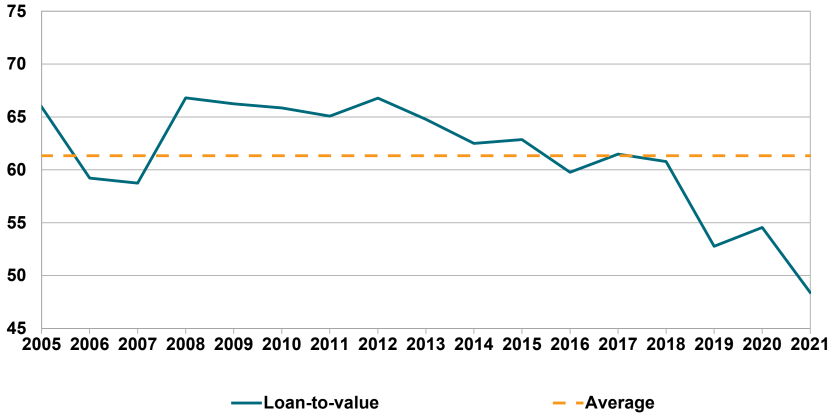


Source: MSCI

Note. Data on an annual frequency covers the period up to and including 2021.

4. Falling loan-to-value ratios

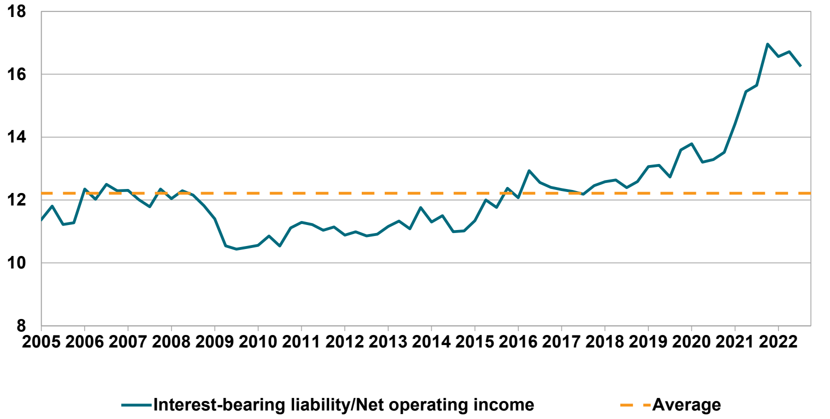
Per cent



Källa: Bisnode.
Note: Refers only to listed real estate companies on Nasdaq OMX Nordic Main Market. Data on an annual frequency covers the period up to and including 2021.

5. CRE firms debt have increased rapidly

Ratio



Source: JLL
Note. The diagram shows the listed CRE firms' interest-bearing liability divided by net operating income. The data covers the period up to and including the third quarter of 2022.

As also stated in the ESRB report on Vulnerabilities in the EEA commercial real estate sector from January 2023, **adverse developments in the CRE sector can have a systemic impact on the financial system and the real economy.** The high debt of many Swedish CRE firms' is adapted to a very low interest rate which may cause problems when interest rates increase. To reduce their debt, during stressed market conditions, many firms may feel forced to sell their properties, adding further downward pressure on prices. A general fall in property prices would weaken the financial ratios of other CRE firms and lead to banks becoming more cautious in their CRE lending. In addition, CRE stress can have negative spillover effects on the real economy,

	through its impact on investments in the economy and particularly the construction sector. The CRE market is sensitive to economic conditions and acts cyclically over time, similar to the state of the economy. **Some of the current CRE vulnerabilities relate to cyclical developments.** The rapid increase in inflation and the tightening of monetary policy will put pressure on the CRE sector. Lower income, higher financing costs and reduced property prices may cause bankruptcies and pose risks to financial stability. **Other vulnerabilities relate to long-term changes, i.e., structural changes, such as a shift towards e-commerce and increasing demand for flexibility in leasable office space** on the CRE market. **In summary, the CRE-related risks are elevated in Sweden since the CRE sector is highly indebted and the banks' exposure to the sector is large.** Many CRE firms are vulnerable to shocks or a deterioration in the macroeconomic conditions. Major problems on the CRE sector could give rise to credit losses at the banks. Since Swedish banks are highly exposed to the CRE sector, there is a need to address CRE risks in the banking sector. A risk weight floor for CRE exposures ensures that the banks hold enough capital for the loss risk specific to CRE lending. That the banks keep enough capital for the loss risk in their lending is crucial for financial stability.
4.2 Analysis of the serious negative consequences or threat to financial stability **(Article 458(2)(b) CRR)**	**Swedish CRE firms are highly indebted**. Their debts make up roughly 35 percent of Swedish gross domestic product. Banks are particularly exposed to the CRE sector. In addition, the sector is important to many financial market actors, such as investment funds, insurance undertakings, pension funds and credit institutions. Adverse developments in the CRE sector can have a systemic impact on both the real economy and the financial system. CRE firms' large debts make them vulnerable, and many can get into problems in a stressed scenario. **Payment problems and insolvency of the CRE firms can lead to credit losses for banks and reduce their capital.** Since CRE firms also borrow significant amounts in the money and capital markets, there may be problems in refinancing maturing market funding if investors become less willing to buy the bonds and certificates of the CRE firms. To refinance maturing market financing, the firms may then need to borrow more from the banks. That would increase the credit risks and capital requirements for banks. If the banks were to suffer from both credit losses and increasing capital requirements for their CRE exposure, their capital strength risks weakening. This could precipitate or deepen an economic downturn. **Even if the banks' CRE problems would not be quite so extensive, they may try to improve their weakened financial position by cutting back on lending to other sectors of the economy.** If lending to credit-worthy households and non-financial companies were to decrease in this way, it would negatively affect economic growth. It is therefore necessary that the banks hold enough capital for the risk of credit loss in their CRE lending.

4.3 Indicators prompting the use of the measure	The main indicators are based on the:
	
	• Assessment of risks and vulnerabilities in the CRE sector, which include indicators for four categories of vulnerabilities:
	    o **Income:** indicators such as rent growth, GDP and change in unemployment rate, Interest coverage ratio of CRE firms, vacancy rates for different regions and segments, granted building permission for CRE (completed and started).
	    o **Collateral value:** Indicators such as CRE prices by region and segment, index and growth, change in the yield

	requirement and net operating income, CRE price growth in relation to growth in CRE firms' net operating income, risk-free interest rate and yield on commercial properties. o **Financing:** Indicators such as Banks' lending to CRE firms (outstanding amount and off-balance), Amount of non-performing bank loans to CRE, Bank exposures to CRE with elevated risk (loans in stage 2 and 3), CRE firms' market financing (bonds and certificates), Bond and certificate maturity, Interest rates, CRE firms' interest and capital fixation periods, CRE firms' loan-to value, CRE firms' Interest-bearing debt to Net operating income. o **Spillover:** Indicators such as CRE market value as percentage of GDP, CRE debt as percentage of GDP, Banks exposure to CRE in relation to lending to public and NFCs, Insurance firms' exposures to CRE, Transaction volumes by domestic and foreign investors • Assessment of how resilient CRE firms are to stressed scenarios and how stressed CRE firms can impact the banks.[9] Indicators for this assessment include: o **Microdata**, which cover detailed data of the banks' loan portfolios. The data include all loans to CRE firms and information for every loan, such as the outstanding amount, provisions, interest rate, transaction date and maturity, banks' PD and LGD estimates and risk weights. Detailed information about the secured property, such as the type of property, geographic location, loan-to-value ratio, valuation method and valuation date. The data also include identification and other detailed information about the counterparty. o **Counterparty data** is matched with information from Bisnode's Serrano database to merge data on the firms' financial position from the annual reports. This data includes a full set of financial statements that are used to calculate the ICR and LTV on firm level.
4.4 Justification for the stricter national measure **(Article 458(2)(c) CRR)**	The objective of the measure is to increase and strengthen resilience in the Swedish banking sector given the risks in the commercial real estate sector. Today, the additional capital in the banking system due to current capital add-ons in pillar 2 amounts to SEK 17 billion or around 4% of the total capital requirement for the largest Swedish banks at the consolidated level. The proposed measure has largely the same impact and is expected to generate SEK 18 billion in additional capital based on Q4 2022 figures. Hence, the measure ads loss-absorbing capital that strengthens the resilience in the banking sector against negative developments in the commercial real estate market or shocks to the macroeconomy at large. By introducing the risk weight floor within the framework of Article 458 of the CRR the already built-up capital, through the current pillar 2 measures, will remain in place in order to be available to address and manage potential future credit losses in the commercial real estate market. This is important

[9] See for example Aranki, Lönnbark and Thell (2020) "Stress test of bank lending to commercial real estate firms", FI Analysis 24, FI, for a more detailed description of the method used to assess the resilience of CRE firms and how stressed CRE firms can impact the banks. Calculations and results of the stress test are also presented in the In-depth analysis – Stress test of commercial real estate firms in the report Stability in the Financial System (2022:2), FI.

	given the vulnerabilities and systemic risks stemming from lending to commercial real estate firms. Moreover, the implementation of the measure through Article 458 aims to ensure a level playing field through the possibility of reciprocity. The measure is of importance from the perspective of the integrated Nordic-Baltic region. The Swedish financial system is characterised by a high degree of interconnectedness with the financial systems of other Nordic and Baltic countries. Swedish banks operate in all countries in the region and hold large market shares in many of them. This is particularly the case in the Baltic countries, where multiple Swedish banks that have been identified as O-SIIs are active. Thus, measures that ensure the resilience of credit institutions and strengthen the stability of the financial system in Sweden also act to ensure the financial stability in the Nordic-Baltic countries and thereby the stability of a substantial part of the EU financial system. **Why other measures or legal bases are not adequate** Article 124 of the CRR Article 124 enables the competent authority, on the basis of financial stability considerations, to increase the risk weights of banks that apply the standardised approach to their CRE exposures. The relevant Swedish CRE exposures are to a small extent held by banks applying the standardised approach, whereas exposures that are risk-weighted according to the IRB approach constitute almost all of that market. Article 124 of the CRR would therefore not be effective in meeting the objectives of the measure as its scope would be severely limited. Swedish banks applying the standardised approach must assign a minimum risk weight of 50% to their exposures secured by commercial real estate in Sweden, which is considered to be sufficient. In contrast, for IRB banks, the average (exposure-weighted) risk weight is around 17% for corporate exposures secured by commercial real estate and 13% for corporate exposures secured by residential real estate. Article 164 of the CRR Article 164 is not applicable to corporate exposures and hence not possible to use for the exposures in question. Article 133 and 136 of Directive 2013/36/EU Pursuant to Article 133, the systemic risk buffer can be used with the objective of preventing and mitigating macroprudential, or systemic risk not covered by the CRR or Articles 130 and 131 of the CRD. Finansinspektionen already applies a systemic risk buffer of 3%, applicable to the three major banks, which addresses risks associated with the large, similar, and concentrated banking sector in Sweden. The systemic risk buffer can be applied to all or a subset of exposures of a credit institution. Hence, it could be used to specifically target CRE exposures. In order to replace the current floor measure, the applicable buffer rate would vary between banks and would have to be set between 20 – 40 % when it comes to exposures secured by commercial real estate and 10 – 25 % for residential real estate.

	The three large banks in Sweden have varying risk weights för their CRE exposures. This variation can increase further during the ongoing IRB review when banks' new models will be approved at different points in time. A sSyRB is therefore not deemed appropriate at present as it would be based on REA and risk weights that vary, which means that it would be very difficult to calibrate the buffer level. In addition, a sectoral SyRB (if calibrated as a single rate) would impact most heavily IRB banks with the highest risk weights and least heavily IRB banks with the lowest risk weights. This is not desirable as the measure intends to address banks with low risk weights. As for Article 136 of the CRD, it enables the use of a countercyclical capital buffer to address cyclical systemic risks. The buffer applies to all credit exposures to the non-financial private sector located in the concerned Member State. The countercyclical buffer rate in Sweden is 1 percent and will increase to 2 percent in June 2023[10]. The countercyclical buffer is applied to all Swedish credit exposures and not just the CRE exposures. If the countercyclical buffer applied to specifically target systemic risks linked to the Swedish CRE market, this would punish other exposures which were not the target of the measure. Moreover, it would have punished most the banks with the lowest share of relevant exposures in CRE loans. Therefore, further increasing the countercyclical capital buffer would not adequately address the identified risk in an effective and proportionate way. Other Measures It is also important to consider the future introduction of the output floor. The proposed measure could act as a bridge, during the period when the output floor is phased in, to avoid unwarranted volatility in the banks' REA when the capital add-ons in Pillar 2 are removed. Summary As such, and on balance, the assessment is made that the 458 measure is most appropriate and effective at this time.
5. Sufficiency, consistency and non-overlap of the policy response	
5.1 Sufficiency of the policy response	The proposed measure provides more loss-absorbing capital than what is calculated by the banks own internal credit risk models, which strengthens the resilience of the banking sector against negative developments in the commercial real estate market or shocks to the macroeconomy at large. As noted in section 4.4, the additional capital from the measure is expected to amount to about SEK 18 billion. Further, as explained in section 2.4, the proposed measure is deemed to be effective as it straightforwardly targets banks' exposures that are linked to the systemic risks in the commercial real estate sector. The proposed measure is not expected to have a material unintended impact on the general economy. As explained in section 2.5, the evaluation of the current Pillar 2-measures showed that they had little effect on banks' interest margins on loans to CRE firms. Further, the evaluation showed no signs of banks increasing risks to maintain profitability (a concern when the floor

[10] https://www.fi.se/en/published/press-releases/2021/fis-approach-to-setting-the-countercyclical-capital-buffer/

	where introduced). CRE firms' borrowing has continued to grow since FI introduced the measure and there are no signs of changes in banks' credit supply to CRE firms or CRE firms' demand for credit. Finansinspektionen assesses that the identified systemic risks linked to IRB banks' CRE exposures are best addressed by setting risk weights at a level that is considered adequate and sufficient. The measure is targeted in its scope, in terms of both concerned exposures and credit institutions covered.
5.2 Consistency of application of the policy response	One of FI's mission is to safeguard the stability in the financial system. From that perspective the CRE market is important as it is large, cyclical sensitive, and closely connected to the financial system. In addition, the indebtedness of the sector is high. Swedish banks have large exposures to the CRE sector. Disturbances following for example changed financing conditions or a worse economic situation could therefore lead to substantial credit losses. Having enough capital in relation to the systemic risks in lending to the CRE sector is hence important for the resilience of banks and financial stability in Sweden. Both the level and the **change in the intensity of macroprudential or systemic risk** are driven by a prolonged period of increasing debt in CRE firms and the large degree of interconnectedness with the financial market as borrowing via capital markets has increased. This is described in more detail under section 4.1. Systemic risks related to the CRE sector have **the potential to have serious negative consequences for the financial system and the real economy**. CRE firms are highly indebted and therefore also vulnerable to disturbances. Furthermore, the CRE sector is important to many financial market actors and adverse developments in the CRE sector can have a systemic impact on both the real economy and the financial system, see section 4.2 for more details. As described in section 4.4, FI makes the assessment that the 458 measure is the most appropriate measure at this time to address the identified risks in the CRE sector and considers that **they cannot be more efficiently addressed by means of other macroprudential tools**. A sSyRB is not deemed appropriate at present both because it would be based on REA and risk weights that vary, which means that it would be very difficult to calibrate the buffer level and also as a sectoral SyRB would impact most heavily IRB banks with the highest risk weights. The measure is consistent with the objective of strengthening and ensuring the resilience of Swedish banks, and by extension the stability of the financial system in Sweden.
5.3 Non-overlap of the policy response	There are no other policy instruments used to address the <u>same</u> systemic risk. When risk weight floors will be implemented in accordance with article 458, the capital add on via Pillar 2 will be removed. The Pillar 2 add on is designed so that it imitates higher risk weighted assets including taking account of buffers.

6. Cross-border and cross-sector impact of the measure	
6.1 Assessment of cross-border effects and the likely impact on the Internal Market **(Article 458(2)(f) CRR and Recommendation ESRB/2015/2[11])**	Finansinspektionen does not expect the measure to have a negative impact on the internal market that would outweigh the financial stability benefits resulting from the increased bank resilience. The measure is considered to have positive internal spillover effects in Sweden as the introduction of the measure will not only support the resilience of the Swedish banking sector but will also support greater stability in the Swedish CRE sector which itself has further links to the Swedish financial system and economy such as through capital markets and direct economic activity. The measure is also considered to have positive outward spillover effects in other countries. As the measure supports the resilience of the Swedish banking sector, those Swedish banks with operations in other countries will be better able to continue lending to the real economy in those countries, thereby supporting financial and economic stability. In addition, if authorities in other countries reciprocate the measure, it may have a positive impact in those countries, as it could increase the loss-absorbing capacity of institutions related to Swedish CRE exposures, thereby supporting financial and economic stability in those countries. Based on our information however, the effect of reciprocation would at present be limited as foreign banks' risk weights are higher or close to the proposed floors. This might however change over time. The proposed measure would apply to all IRB banks with Swedish commercial real estate exposures. All significant lenders in the Swedish commercial real estate sector are consolidated in Sweden, except for the Swedish branches of Danske Bank and Nordea. Reciprocity in the application of the proposed measure is important in order to avoid leakages and regulatory arbitrage. In this context, Finansinspektionen emphasises that a Memorandum of Understanding (MoU) on prudential supervision of significant branches applies to the Nordic-Baltic macroprudential network.[12] The competent authorities in the region acknowledge the importance of reciprocity of macroprudential measures in general, and in particular as a means to prevent banks from circumventing the measures by transferring operations to other countries. The authorities, thereby, recognise the importance of reciprocity as a means of ensuring a level playing field and a well-functioning internal market. The authorities also acknowledge Recommendation ESRB/2015/2 as a minimum standard for reciprocity in macroprudential matters. Note also that an additional MoU on cooperation and coordination on cross-border financial stability was signed in 2018 by the

[11] Recommendation of the European Systemic Risk Board of 15 December 2015 on the assessment of cross-border effects of and voluntary reciprocity for macroprudential policy measures (ESRB/2015/3) (OJ C 97, 12.3.2016, p. 9).
[12] See https://www.fi.se/contentassets/dbde31519a7543a18808d3db1deacb4e/mou-filialer-nordiska-lander2016-12-19n.pdf and https://www.fi.se/contentassets/282187c73694429cbfddce78f001d556/mou_ecb_2017-05-29ny3.pdf.

	ministries of finance, financial supervisory authorities, central banks and resolution authorities of the Nordic-Baltic countries.[13] The Nordic and Baltic countries have common financial stability interests stemming from inter-linkages in the financial system in the region. This has resulted in a close cooperation between the countries to facilitate and support measures taken by reciprocating them even long before there was a MoU in place. Finansinspektionen assesses that the proposed measure will have a positive impact on the Internal Market. The positive consequences are the direct result of the financial stability benefits in terms of reducing and mitigating the macroprudential or systemic risk identified. This is increasingly important in the context of the financial interlinkages in the Nordic-Baltic region and the enhanced cross-border dimension of the Swedish financial sector.
6.2 Assessment of leakages and regulatory arbitrage within the notifying Member State	Finansinspektionen will monitor closely the impact of the measure on other sectors of the Swedish financial system. As noted in section 4.1, although bank loans are still the largest source of financing for most CRE firms, borrowing via the capital market has become increasingly important. It is not considered however that the growth in market lending is directly related to the previous introduction of higher capital requirements for banks, including requirements specific to commercial real estate lending. Indeed, the growth in market lending predates the previous introduction of higher capital requirements for banks for commercial real estate lending. In addition, bank lending to commercial real estate has continued to grow significantly in recent years despite higher capital requirements. In any case, as the proposed risk weight floor is not expected to materially affect bank's capital requirements, it is not expected that the measure should lead to material increased leakage or regulatory arbitrage. FI will monitor developments closely in order to continuously assess the effectiveness of the measure.
6.3 Request for reciprocation by other Member States **(Article 458(8) CRR and Recommendation ESRB/2015/2)**	Do you intend to ask the ESRB to issue a recommendation to other Member States to reciprocate the measure in accordance with Article 458(8) CRR? Yes

[13] See https://www.fi.se/en/published/news/2018/new-nordic-baltic-memorandum-of-understanding.

6.4 Justification for the request for reciprocation by other Member States **(Article 458(8) CRR and Recommendation ESRB/2015/2)**	Finansinspektionen requests that the ESRB recommends that other Member States reciprocate the risk-weight floor for exposures secured on commercial property, as their banking sector is exposed through their branches to the risk related to the commercial real estate market in Sweden. Reciprocity requests will also be sent directly to the relevant macroprudential authorities of the most affected Member States where needed. Finansinspektionen proposes that the institution-level materiality threshold should be set at [SEK 5 billion], which is equivalent to about [0.5%] of bank lending to CRE in Sweden. This threshold has been calibrated in accordance with the principles in the reciprocity framework as established by the ESRB, taking into account the guiding principles on the calibration of the threshold level. The threshold is lower than the 1% level that is suggested as a potential starting point in the reciprocity framework. As certain banking groups headquartered in other countries operate in Sweden through both subsidiaries and branches – and can potentially vary through which entity CRE lending is carried out – the threshold aims to limit the possibility to avoid the proposed measure through shifting the location of activity in the group. Reciprocation will ensure the effectiveness of the measure in achieving the macroprudential goal of safeguarding the resilience of the Swedish banking sector to risks in the commercial real estate market.
7. Miscellaneous	
7.1 Contact person(s)/mailbox at notifying authority	Sara Ehnlund Martinussen +46 8 408 984 09 sara.ehnlundmartinussen@fi.se Richard Williams +46 8 408 980 81 richard.williams@fi.se
7.2 Any other relevant information	
7.3 Date of the notification	12/05/2023