Decision of the Board of the Financial Supervisory Authority on setting an additional capital requirement on the basis of the structural characteristics of the financial system (systemic risk buffer)

At its meeting on 28 June 2019, the Board of the Financial Supervisory Authority (FIN-FSA) has decided:

- to maintain the current level of the additional capital requirement referred to in chapter 10, sections 4 and 6a of the Credit Institutions Act, to be met with Common Equity Tier 1 capital and determined on the basis of the structural characteristics of the financial system (systemic risk buffer), as calculated on the basis of the total risk exposure of the ultimate Finnish parent company of a consolidation group or an amalgamation of deposit banks, as follows:
    - Nordea Group 3.0%
    - OP Financial Group 2.0%
    - Municipality Finance Plc 1.5%
    - other credit institutions 1.0% (Aktia Bank Plc, Danske Mortgage Bank Plc, Evli Bank Plc, Handelsbanken Finance Plc, Oma Savings Bank Plc, POP Bank Group, S-Bank Ltd, Mortgage Society of Finland Group, Savings Banks Group and Bank of Åland Plc). The decision of the Board on the systemic risk buffer will enter into force on 1 July 2020.
- to reassess the level of the buffer at the latest during the first six months of 2020.

Justifications for the decision

Based on an analysis made, the Board of the FIN-FSA considers that the structural systemic risks in Finland's financial system are currently so high that it is justified to keep the systemic risk buffer imposed on 29 June 2018 on all credit institutions unchanged. Hence, the requirement will remain at 1.0% for other credit institutions, at 3.0% for the Nordea Group, at 2.0% for OP Financial Group and at 1.5% for Municipality Finance Plc due to their greater importance than the others.

1. Requirements established in legislation for the use of the systemic risk buffer

According to Article 133 of the EU Capital Requirements Directive, a Member State may introduce a systemic risk buffer for the financial sector or one or more subsets of that sector in addition to other capital requirements. The objective of the systemic risk buffer is to prevent and mitigate long-term non-cyclical systemic or macroprudential risks not covered by the Capital Requirements Regulation that might have serious negative consequences to the financial system and the real economy in a specific Member State.

In accordance with chapter 10, section 6a of the Credit Institutions Act, application of the buffer requires that

a) a risk arising from long-term non-cyclical threats to the financial system or the macroeconomy requires a higher capital requirement;
b) this risk poses or might pose a threat at the national level to the smooth functioning and stability of the financial system; and
c) other instruments intended for macroprudential supervision (excluding the instruments referred to in Articles 458 and 459 of the EU Capital Requirements Regulation) have not been adequate or otherwise suitable for covering the capital requirement.

In accordance with the Credit Institutions Act, a systemic risk buffer shall be imposed at the level of the highest Finnish parent company of a consolidation group or at the level of the amalgamation of deposit banks.

The Credit Institutions Act provides on seven risk factors which must be considered in deciding on the systemic risk buffer:
1. Risk concentrations in the credit institution sector in lending, funding and other core banking functions;
2. Mutual interconnectedness of domestic credit institutions in lending, payment transmission and other banking functions that are important for financial stability;
3. Interconnectedness of the credit institution sector to foreign banking and financial system, central counterparties and other financial market participants;
4. Interconnectedness of the credit institution sector to the risks of the financial systems of EU member countries and other countries;
5. Size and concentration of the credit institution sector as measured by balance sheet size and concentration in lending and reception of retail deposits;
6. Significance of the credit institution sector in the intermediation of finance to the domestic private sector;
7. Indebtedness of the credit institutions' largest customer groups.

In addition, a Decree of the Ministry of Finance supplementing the Act determines the indicators for the measurement of the risk factors referred to in the Act.[1]

Risks constituting the basis for the application of the systemic risk buffer

In accordance with the Decree, the systemic risk buffer may be imposed at the level of 3 percent at the maximum, if the structural systemic risk affecting Finnish credit institutions, based on the indicators and an overall assessment, is higher than the average systemic risk in EU member states or euro area countries or where systemic risk is higher than the long-term average based on at least three indicators for Finland, and at a level higher than 3 percent and at the maximum 5 percent, if the systemic risk based on the above comparisons is *clearly* above the EU/euro area average or the long-term average.

[1] Decree (65/2018) of the Ministry of Finance on an additional capital requirement determined on the basis of the structural characteristics of the financial system for a credit institution and investment firm.

Structural systemic risks identified in the Finnish financial system have mainly remained unchanged after the previous decision concerning the systemic risk buffer. Nordea's re-domiciliation to Finland, which was taken into account in the conditional decision of June 2018, took place as planned. Nordea's re-domiciliation to Finland increased the systemic risks related to the Finnish banking sector significantly, both from an institutional perspective and by strengthening linkages to the Nordic banking markets.

Finland's financial system is currently structurally vulnerable, and the structural systemic risks favour the setting of a systemic risk buffer. It is warranted to determine the systemic risk buffer based on structural, long-term risks in a manner emphasising the continuity, consistency and predictability of requirements imposed and to be imposed for structural systemic risks.

The key justifications for the imposition of the systemic risk buffer in Finland are the following:

- Finland's credit institution sector is concentrated and also large compared to the size of the economy as well as strongly interconnected with the financial systems of the other Nordic countries
- The credit institutions have a key role in providing financial services.
- Finnish credit institutions have risk concentrations in common, particularly housing loans and receivables from construction and real estate sector companies.
- Finnish credit institutions are dependent on funding obtained from the financial market because the difference between loans to the public and deposits from the public (funding gap) is large.
- The indebtedness of the largest borrowing sectors, particularly households, is high.

The interconnectedness of the Finnish credit institution sector through interbank deposits has strengthened significantly due to Nordea's re-domiciliation, but it remains close to the average level of the EU. The risk concentrations of the credit institution sector in domestic government bond claims still do not constitute a major structural threat.

A comparison of Finland's and the other EU countries' systemic risks, based on the indicators under the Decree of the Ministry of Finance, provides strong justifications for setting a systemic risk buffer requirement at the level of 1–3%. A quantitative overall assessment that the structural systemic risks of Finland's credit institutions sector are higher than in other EU countries on average is primarily justified by the fact that the values of eight of the 11 indicators according to the decree are higher in Finland than the median of the values of other EU countries' indicators. In addition, the values of seven indicators are higher in Finland than the average of other EU countries' indicators, which also favours the overall assessment made.

The overall assessment of Finland's structural systemic risks has taken into account the fact that the available risk indicators in the decree supplementing the Credit Institutions Act that report on EU countries are based on statistical data in the interpretation of which particular care must be exercised when assessing the structural systemic risks of Finland and other EU countries. The Ministry of Finance decree specifying in more detail the conditions for setting a systemic risk buffer also emphasises the importance of the FIN-FSA's overall assessment when deciding on the requirements.

<u>Potential impacts of risks on the smooth functioning and stability of the financial system</u>

The structural risks mentioned pose or might pose a threat at the national level to the smooth functioning and stability of the financial system. This is indicated by the following aspects, in particular:

- Given that the credit institutions sector is very important as a provider of financial services, serious difficulties encountered by credit institutions could adversely affect financial intermediation significantly and thereby have a considerable negative impact on the real economy.
- Since the credit institutions sector is concentrated, difficulties encountered by the largest individual credit institutions would give rise to significant shortcomings in the provision of financial services to the real economy, and replacing the services would require significant capital and other capacity from other credit institutions.
- Serious shocks affecting the credit institutions sector's significant risk concentrations (housing loans and loans granted to construction and real estate sector companies) could pose a direct or indirect threat to the functional capacity of a number of credit institutions. The significance of the risk concentration in housing loans is increased by households' high indebtedness.
- The credit institution sector' dependence on market funding increases credit institutions' vulnerability to financial disruptions in problem situations.

<u>Adequacy of other macroprudential tools and applicability to covering the capital need necessitated by the risks</u>

Pursuant to the Credit Institutions Act, a condition for using a systemic risk buffer is that other instruments intended for macroprudential supervision (excluding the instruments referred to in Articles 458 and 459 of the EU Capital Requirements Regulation) have not been adequate or otherwise suitable for covering the capital requirement. It is therefore justified to base the quantitative estimate of structural systemic risks primarily on the use of the median, i.e. the middle value in the distribution's ordered list of numerical values, when measuring the average systemic risk of the other EU countries.

- The purpose of the countercyclical capital buffer is to counteract cyclical systemic risks and their effects, and therefore it is not suitable for use in the case of structural systemic risks.
- An additional capital requirement for global and other systemically important credit institutions is set for individual credit institutions or groups to combat, in accordance with specific criteria, the institution-specific systemic risks they pose to the financial system. The requirement is not therefore directed at systemic risks relating to the structure of the whole financial system. Furthermore, the additional capital requirement for other systemically important institutions (so-called O-SII buffer) can presently be established at the level of 2% at the maximum, which may be inadequate for some credit institutions to cover all structural risks caused by them.
- Influencing the risk weights of credit institutions' loans secured by mortgages on immovable property in accordance with Articles 124 and 164 of the EU Capital Requirements Regulation would be directed at credit institutions depending on the current risk weights of credit institutions' loans secured by mortgages on immovable property and also on their exposures to these loans. The instrument in question is therefore not directed sufficiently widely at credit institutions' capital adequacy requirements to ensure their adequate capitalisation for structural systemic risks.
- The maximum loan to value ratio for housing loans does not impose requirements for credit institutions' capital adequacy and leverage and therefore is not suitable for ensuring credit institutions' adequate capitalisation for structural systemic risks.

2. Justifications for the allocation and level of the systemic risk buffer

The primary objective of the requirement concerning the systemic risk buffer is to ensure that credit institutions have adequate capital requirements to cover structural systemic risks. In current circumstances, there are grounds to impose the requirement on credit institutions' total risk exposure, taking into account individual credit institutions' risk items located in other EEA countries.

It is possible to establish the systemic risk buffer to the entire credit institution sector at the same level. The requirement may also be targeted at those credit institutions for which recognised systemic risks give rise to capital requirements. Different levels of systemic risk buffer can be imposed on different parts of the sector.

<u>Justifications for allocating the systemic risk buffer requirement to the entire credit institution sector at the minimum level of 1.0%</u>

Imposition of the systemic risk buffer at 1.0% to the entire credit institution sector is based on extensive overall assessment. The justification for the decision are largely the same as in the decision of the Board of the FIN-FSA of 29 June 2018 on the imposition of the systemic risk buffer. The risk posed by the recognised structural risk factors of Finland's financial system is directed generally at the whole credit institutions sector. The structural risks and exposures to them are largely the same and interconnected, despite the size of the credit institution. For a centralised sector significant for financial intermediation to be able to function also in the event of disruptions, it is important for it to be well capitalised as a whole.

In targeting the systemic risk buffer, due consideration has been given to the fact that, alongside the three largest credit institutions, the importance of the other credit institutions from the perspective of the operation of Finland's credit market is higher than that based on an balance sheet analysis. According to market share statistics published on the Bank of Finland's website, in lending the Nordea Group, OP Financial Group and Municipality Finance account for a combined market share of (at end-2018) just over 70%, Danske Bank and Svenska Handelsbanken, which operate partly via branches, around 15% and the other credit institutions slightly less than 15%. In housing loans, the other credit institutions' share is over 15%.

According to the Credit Institutions Act, the additional capital requirement must be reasonable and proportionate to the risk in question. In assessing the level of the additional capital requirements, it is justified to emphasise the exposure of the entire sector to systemic risk.

It was deemed warranted to set the requirement concerning the systemic risk buffer for the entire credit institution sector at the previously determined, lowest possible positive level allowed by legislation. Hence, the level of the requirement would not contain lending to a significant degree in the short term and constitute a hindrance to continuing economic growth.

Justifications for imposing the systemic risk buffer at a level higher than 1.0% for specifically designated credit institutions

The systemic risk buffer can be justifiably set higher than the general level for credit institutions whose impact on the formation of systemic risk is significantly higher than the impact of other credit institutions. The higher level will help prevent the formation and expansion of systemic risk via these key credit institutions.

The imposition of the requirements concerning the systemic risk buffer at a higher level than the general level for specific credit institutions is based on extensive overall consideration taking broadly into account the preconditions and objectives of setting a systemic risk buffer and the impacts of the requirement. Hence, the requirements cannot be based on, for example, mechanistic interpretation of isolated indicator observations. Individual credit institutions' systemic risk buffers that are determined higher than the general level must beet the statutory requirements for such determination.

In imposing and determining the requirements concerning the systemic risk buffer at a higher level than the general level, the following factors were taken into account as core justifications.

1. The first factor in the imposition and sizing of the credit-institution-specific systemic risk buffer is *the impact of the credit institution on the formation of structural risks in the Finnish financial system.* Since there is no unambiguous indicator for the formation of impacts, it is warranted to assess the credit-institution-specific impacts from various perspectives:

a) One justified perspective is to assess of each credit institution has affected the emergence of structural systemic risks regarding the indicators constituting the statutory grounds for the imposition of the requirement concerning the systemic risk buffer. This kind of an impact calculation implies that three credit institutions have a clearly larger impact on the structural risks based on the indicators under scrutiny (approximate contribution values: Nordea 41%, OP Financial Group 28% and Municipality Finance 9%, other individual credit institutions no more than 3%).

b) Another justified perspective is to assess the structural systemic risks caused by credit institutions to the financial system and its smooth functioning by measuring them with scoring methodologies applicable to the determination of systemically important institutions (so-called O-SII scores). The O-SII scoring implies even larger differences in impacts on structural risks than those mentioned above (approximate O-SII scores: Nordea 69%, OP Financial Group 11%, Municipality Finance 3%, other credit institutions 1%).

c) In addition to the abovementioned quantitative indicators, the overall assessment of the systemic risk buffers considers other impacts of credit institutions on the structural risks of the domestic financial system. In this assessment, attention has been paid among other things to the impact of ensuring adequate capitalisation on ensuring credit institutions' operating preconditions (including the risk-reducing impact of adequate capitalisation) In addition, the need to ensure the functioning of the most important credit institutions in the event of crises which cannot be determined comprehensively on the basis of statistical data.

2. In addition to the structural risks caused to the Finnish financial system, it was taken into account *what the impact of credit institutions on structural risks is like in other financial systems and how credit institutions affect the transmission of risks between the Finnish financial system and other financial systems*.

3. Other principles taken into account in the overall assessment concerning the setting of the systemic risk buffers higher than the general requirement included *continuity, consistency and predictability.*

As regards continuity, the decision of the Board of the FIN-FSA of 29 June 2018 on the systemic risk buffer was taken into account. In order to ensure continuity and predictability, it is warranted that the level of requirements concerning the systemic risk buffer for long-term risks independent of cyclical fluctuations is not changed without strong justifications.

From the perspective of the continuity of requirements to prepare for structural systemic risks, also the requirements applicable to Nordea before its re-domiciliation to Finland were also taken into account.

From the perspective of consistency, the requirements concerning the systemic risk buffer in Finland were compared to corresponding requirements in other EU countries. In particular, the requirements set to cover structural systemic risk in other member states of the EU's banking union and other Nordic countries were reviewed.

Advantages related to the banking union and particularly the joint supervision thereof and crisis resolution were taken into account as factors mitigating the need for a systemic risk buffer for the most significant credit institutions. Within the banking union, the level of the systemic risk buffer is currently 3% at most, even though a number of credit institutions operating in the banking union are, overall, larger and, from the perspective of the financial stability of the whole banking union, more significant than Nordea. On the other hand, in proportion to the economy of its home country, the Nordea Group is the largest credit institution of the banking union countries.

Among the significant Finnish credit institutions, the Nordea Group in particular engages in extensive banking operations in several Nordic countries. In order to ensure a level playing field, attention was therefore paid on systemic risk buffer requirements or corresponding requirements (incl. Pillar 2 requirements) in those Nordic countries where the group has significant operations (Sweden, Norway, Denmark). In these countries, the systemic risk buffer and other corresponding requirements for the systemically most important banks amount to at least 3%.

In contrast, there were no grounds to take into account the level of the countercyclical capital buffer in different EU countries in this review. First of all, the imposition of this requirement is based on cyclically dependent systemic risks as opposed to the imposition of the systemic risk buffer based on structural systemic risks. Secondly, the level of the countercyclical capital buffer does not depend on the country of location of the credit institution, but on the country to which credit is granted.

3. Impact assessment of the systemic risk buffer

The imputed impact of the systemic risk buffer requirements on the CET1 capital requirement is €6.2 billion on the basis of the figures as at 31 March 2019. The systemic risk buffers increase the aggregated effective CET1 requirements for the Finnish credit institution sector by some €1.5 billion, corresponding to slightly less than 40% of the combined annual profits of the sector in 2018.

4. Other aspects

Within the framework of the banking union's Single Supervisory Mechanism, the European Central Bank reviews, in the light of a notification made to it, the adequacy of any systemic risk buffer level being imposed. The ECB therefore has an opportunity to react to decisions made and also at a later stage to impose a systemic risk buffer requirement at a higher level than that decided by the national authority, if the decided level is deemed to be insufficient.

The FIN-FSA has consulted, in accordance with section 34 of the Administrative Procedure Act, the credit institutions concerned by the decision on the systemic risk buffer.

In their responses, the credit institutions questioned the application of the systemic risk buffer to all credit institutions, particularly small ones. Small credit institutions apply the standardised approach to credit risk, as a consequence of which the capital effect of the systemic risk buffer is emphasised. Those who provided statements also found it important to take into account other capital requirements already imposed and the stability benefits provided by the banking union. According to the consultees, it is also problematic that the capital requirements imposed by different countries may in some cases overlap. Therefore, it would be important to assess the social benefits and costs of the capital requirements comprehensively.

The credit institutions also emphasised that the largest costs resulting from additional capital requirements to credit institutions are caused by the so-called MREL requirements of the Bank Recovery and Resolution Directive. In the credit institutions opinion, the FIN-FSA should analyse the impact of increased costs on lending and the real economy, similarly to the additional impacts caused by regulation concerning financial and insurance conglomerates. New CRD5/CRR2 regulation requires the reassessment of the buffers in order that the impact would not be unreasonable. According to the responses, the indicators of the systemic risk buffer also include deficiencies and room for interpretation. In addition, the credit institutions hoped for more information on individual contributions to systemic risk and how these translate into capital requirements.

The objective of extending the systemic risk buffer more comprehensively to credit institutions is apparent in legislation. By European standards, the Finnish financial markets are concentrated, which means in practice that there are strong interlinkages between the market participants. All credit institutions contribute to the systemic risk of the financial markets depending on the scope of their activities. The capital impact of the systemic risk buffer is partly determined on the basis of the risk weights applied. Hence, the capital requirements for credit institutions applying internal models may be in relative terms lower than the requirements for other credit institutions. In its impact assessments, the FIN-FSA also considers the benefits and costs of combined capital requirements and the progress made regarding the banking union. In international banking, it is possible that such circumstances emerge where capital requirements imposed by different countries pertain to the same asset items. However, in these cases the objectives of the capital requirements are different.

The Bank Recovery and Resolution Directive determines the so-called MREL requirement level, which may be fulfilled by eligible instruments. Capital requirements increase this level and have an indirect impact on the costs of market funding. The FIN-FSA analyses the impact of increased costs on lending and the real economy, similarly to the additional impacts caused by regulation concerning financial and insurance conglomerates. As a result of the entry into force of the new CRD5/CRR2 regulation, the FIN-FSA will reassess the capital requirements and, in the same context, also the detailed requirements for the application of the systemic risk buffer (including the appropriateness of the indicators).

As part of the consultation procedure, the FIN-FSA offered credit institutions an opportunity to have bilateral discussions clarifying the background and grounds of the decisions. The FIN-FSA takes the feedback received by it into account among other things by affirming that it will review the decision concerning the imposition of the systemic risk buffer at the latest during the six first months of 2020 and by providing additional information in connection with the decision making to credit institutions which have requested it. The FIN-FSA reviews the level of the systemic risk buffer on an annual basis in cooperation with the Ministry of Finance and the Bank of Finland in accordance with the requirements of the Credit Institutions Act.

The decision concerning the systemic risk buffer is notified, in accordance with the Credit Requirements Directive, to the EU Commission, the European Systemic Risk Board (ESRB), the European Banking Authority (EBA) and the authorities of the other EEA member states concerned.