Principles for setting an additional capital requirement on the basis of the structural characteristics of the financial system (systemic risk buffer)

1 Background

Risk arising from the structural characteristics of the financial system means that disruptions directed at the financial system or a part of it may result in particularly serious negative effects on the functioning of the whole financial system or a significant part of it and on the real economy due to the vulnerable structure of the financial system.

The financial system may be structurally vulnerable if the credit institutions sector is, for example, strongly centralised, credit institutions are strongly linked either to each other or to foreign operators, or they have large common risk concentrations in lending or funding.

Ensuring the functioning of a structurally vulnerable credit institutions sector even in the event of serious disruptions may favour stronger than usual capital adequacy. The Member States of the European Union have the option, under Article 133 of the Credit Institutions Directive, to impose on banks a separate additional capital requirement to prevent and mitigate long-term non-cyclical systemic risks or macroprudential risks. As of 1 January 2018, Finland's Credit Institutions Act has been supplemented by provisions enabling the imposition of this additional capital requirement (systemic risk buffer). According to the Directive, an additional capital requirement to be imposed on the basis of structural characteristics may be set nationally either on all banks or only some of them. The decision on the imposition of an additional capital buffer requirement and on determining the institutions on which the buffer will be applied is made in Finland by the Financial Supervisory Authority (FIN-FSA).

2 Regulatory provisions on the systemic risk buffer

2.1 Credit Institutions Act (Chapter 10 Sections 4, 6a and 9)

The FIN-FSA shall, in cooperation with the Ministry of Finance and the Bank of Finland, assess on an annual basis whether there is a need to impose an additional capital requirement on the basis of the structural characteristics of the financial system, to change an existing requirement or to keep it unchanged. A decision on the matter shall be made within six calendar months from the end of each year.

The FIN-FSA may impose an additional capital requirement on the basis of the structural characteristics of the financial system, if:

1) a risk arising from long-term non-cyclical threats to the financial system or the macroeconomy requires a higher capital requirement;

2) the risk referred to in paragraph 1 threatens or might threaten the smooth functioning and stability of the financial system; and

3) 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 applying this section, the FIN-FSA shall take into consideration:

1) credit concentrations of the credit institutions sector in lending, funding and other key banking functions;

2) the mutual interconnectedness of domestic credit institutions in lending, payment transfers and other banking functions important for financial stability;

3) the interconnectedness of the credit institutions sector with foreign banking and financial systems, central counterparties and other financial market actors;

4) interconnectedness of the credit institutions sector with the financial systemic risks of European Union Member States and other countries;

5) the size and concentration of the credit institutions sector as measured by the size of credit institutions' balance sheets as well as concentration in lending and acceptance of retail deposits;

6) the importance of the credit institutions sector in financial intermediation for the domestic private sector;

7) the indebtedness of credit institutions' largest customer groups.

The additional capital requirement must be reasonable and proportional to the risk in question. When setting an additional capital requirement, recommendations and warnings issued by the European Systemic Risk Board shall also be taken into consideration insofar as they apply to Finland's financial market.

The systemic risk buffer must be coordinated with the additional capital requirements of global (G-SII/B) or other systemically important financial institutions (O-SII). If an additional capital requirement in accordance with a systemic risk buffer is determined on the basis of the credit institution's total risk, the credit institution need only fulfil the higher of these requirements. If an additional capital requirement in accordance with a systemic risk buffer only covers domestic and third-country balance sheet and off-balance sheet items, the credit institution must fulfil both additional capital requirements.

2.2 Ministry of Finance Decree (65/2018)

A Ministry of Finance decree provides more detailed provisions on factors relating to the criteria for setting an additional capital requirement. The decree specifies 11 indicators that may be used to assess the components of the risk arising from structural characteristics of the financial system.

An additional capital requirement of 1-3% may be imposed if, based on an overall assessment of indicators describing the components of the systemic risk as well as the magnitude of the systemic risk, the FIN-FSA can assess that the structural systemic risk to Finnish credit institutions is higher, on average, than the systemic risk, assessed in a similar manner, to the credit institutions of other EU countries or other euro area countries or if, on the basis of at least three indicators describing Finland, the systemic risk is higher than the long-term average.

An additional capital requirement of more than 3% and no higher than 5% may be imposed if, based on an overall assessment of indicators describing the components of the systemic risk as well as the magnitude of the systemic risk, the FIN-FSA can assess that the structural systemic risk to Finnish credit institutions is significantly higher, on average, than the systemic risk, assessed in a similar manner, to the credit institutions of other EU countries or other euro area countries or if, on the basis of at least three indicators describing Finland, the systemic risk is significantly higher than the long-term average.

3 Assessment of conditions for setting a systemic risk buffer, and additional capital requirements

3.1 Assessment framework

When assessing whether Finland’s systemic risk on the basis of a single indicator “is higher, on average, than the systemic risk, assessed in a similar manner, to the credit institutions of other EU countries or other euro area countries”, the value of the indicator in Finland is compared with the median of the values of the corresponding indicators of EU or euro area countries. Applying the median helps avoid, for example, the impact on the countries’ average value of highly exceptional indicator values of individual Member States, which could result in distorted conclusions. For Finland’s systemic risk to be “significantly higher, on average, than the systemic risk, assessed in a similar manner, to the credit institutions of other EU countries or other euro area countries”, it is justified to require that the indicator value in Finland exceeds the value of the third quartile of the reference group, i.e. the value of the indicator examined in three quarters of the reference countries is lower than the value of the indicator in Finland.

When assessing, in turn, whether the systemic risk on the basis of a certain indicator is higher than Finland’s long-term average, the latest value of the indicator is compared with the average of all observation data for Finland. For the current systemic risk to be significantly higher than the long-term average would also, as in the case for all EU countries, require that the latest value is higher than the value of the third quartile of observations for Finland.

The values obtained by the indicators specified in the Ministry of Finance decree are presented in Figure 1. The time series used in calculating the indicators are documented in Annex https://www.suomenpankki.fi/en/Statistics/chart-gallery/

Figure 1

Table 1. Indicator	EU comparison	Finnish history
1. Housing loans granted to domestic households as a proportion of total loans granted by the credit institution sector to the private sector	Clearly higher	Higher
2. Credit institution's claims on construction and real estate companies as a proportion of credit institutions' total assets	Clearly higher	Higher
3. Credit institutions' domestic government bond assets relative to credit institutions' total assets	Not higher	Not higher
4. Domestic credit institutions' interbank deposits as a proportion of the total liabilities of the credit institution sector	Not higher	Higher
5. Funding deficit of the credit institution sector in various countries	Clearly higher	Not higher
6. Combined balance sheet total of foreign banks' subsidiaries and branches relative to gross domestic product in various countries	Clearly higher	Not higher
7. Balance sheet of the credit institution sector relative to nominal gross domestic product	Above	Not above
8. Combined balance sheet of the five largest credit institutions relative to the aggregate balance sheet of the entire credit institution sector	Not higher	Not higher
9. Loans granted by domestic credit institutions to households and non-financial corporations as a proportion of households' and non-financial corporations' total liabilities	Higher	Clearly higher
10. Household sector's liabilities relative to households' disposable income	Higher	Clearly higher
11. Non-financial corporations' indebtedness relative to gross domestic product	Higher	Higher
Based on data available on 15 June 2018. Source: European Central Bank.		

Based on a comparison of indicators, the criteria for setting a 1-3% requirement are strong. Of the 11 indicators in the decree, the value of eight is higher in Finland than the median of the values of the other EU countries' indicators and the value of six indicators is higher than Finland's own history. In the light of the indicators in the decree, justifications could also be presented for setting a systemic risk buffer of more than 3%. In the comparison with EU countries four, and in relation to Finland's own history, three indicators out of 11 are clearly higher than the reference level.

The overall assessment of Finland's structural systemic risk 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 collectively determined statistical data that vary in terms of coverage and in the interpretation of which particular care must be exercised when comparing structural systemic risks in Finland with corresponding risks in 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 alongside the indicators when deciding on the requirements.

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. Both the indicator values and the overall assessment favour the setting of a systemic risk buffer of at least 1% for the whole credit institutions sector.

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 setting of a systemic risk buffer for Nordea of 3.0%, for OP Group of 2.0% and for Municipality Finance Plc of 1.5% is based on an assessment of the extent to which a single credit institution contributes to, i.e. has the effect of increasing, systemic risk. This contribution has been calculated, where applicable, in accordance with the indicators and principles specified in the Ministry of Finance decree. According to the calculation, Nordea's contribution to Finland's systemic risk is around 40%, OP Group's around 30% and Municipality Finance Plc's around 10%.

The overall assessment of Finland's structural systemic risk and the attribution of capital requirements to individual credit institutions have 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 alongside the indicators when deciding on the requirements.

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. In accordance with the following considerations, other available macroprudential instruments are not adequate or suitable to ensure the sufficient capitalisation of credit institutions:

- 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.
- 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.

The direct effects of the imposed systemic risk buffer requirement on the capital needs of Finnish credit institutions are considered to be minor. According to the assessment, the banks will have no need to increase their capital adequacy ratio immediately in order to fulfil the requirement. It may be assumed, however, that the banks will adjust their capital adequacy ratios at least in part so that the size of their voluntary capital buffers would gradually return towards the level preceding the imposition of the requirement. In the long term, the measure would therefore increase the capital adequacy of the banks and therefore their risk absorbency for structural systemic risks.

According to an analysis by a Ministry of Finance expert working group that assessed the systemic risk buffer, imposing a 1% requirement on most of the banking sector would increase interest rates on loans by five basis points and would reduce the level of GDP by significantly less than 0.1%. The recommended requirement would increase the capital requirement of a single bank from the current level by no more than one percentage point, but would not in practice increase Nordea's requirement, for example, from its current level. Therefore, the estimated impact of the recommended measure would be minor, in the assessment of the Ministry of Finance working group.

3.2 Additional capital requirements

According to the decision made by the Board of the FIN-FSA on 29 June 2018 with respect to the level of the additional capital requirement 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), the consolidated total risk of the ultimate Finnish parent company of a consolidation group or an amalgamation of deposit banks is as follows:

- Municipality Finance Plc 1.5%
- Nordea-group 3.0%
- OP Group 2.0%
- 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 systemic buffer requirements according to the decision will take effect on 1 July 2019.