FIN-FSA
FINANSSIVALVONTA

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Unrestricted

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 shocks affecting 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 RequirementsRegulation, 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 for 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 *clearly* 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 for Finland, the systemic risk is clearly 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 "clearly 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. In order that the current systemic risk would be defined clearly higher than the long-term average, the most recent value of the indicator for Finland would have to be more than 5% higher than the historical average of the indicator values.

The values shown by the indicators determined in the Decree of the Ministry of Finance are presented in Table 1. The time series used in the calculation of the indicators are documented at the Bank of Finland's website: https://www.suomenpankki.fi/en/Statistics/chart-gallery/

Table 1: Comparison of the observations of the structural indicators for Finland with the median of the EU countries and the average of the historical observations for Finland.

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	Higher	Higher
2. Credit institution's claims on construction and real estate companies as a proportion of credit institutions' total assets	Higher	Not 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	Higher	Higher
5. Funding deficit of the credit institution sector in various countries	Higher	Higher
6. Combined balance sheet total of foreign banks' subsidiaries and branches relative to gross domestic product in various countries	Not higher	Not higher
7. Balance sheet of the credit institution sector relative to nominal gross domestic product	Higher	Higher
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	Higher
10. Household sector's liabilities relative to households' disposable income	Higher	Higher
11. Non-financial corporations' indebtedness relative to gross domestic product	Higher	Higher

Based on data available on 9 April 2019.
Source: European Central Bank.

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.

The current structure of Finland's financial system is 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 institutions 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 within the EU. The risk concentrations of the credit institution sector in domestic government bond claims still do not constitute a major structural threat.

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.
- As 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 disruptions to 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 institutions' dependence on market funding increases credit institutions' vulnerability to financial disruptions in problem situations.

The abovementioned risks require higher level of capitalisation from credit institutions, since the risks may pose a threat to the smooth operation and stability of the financial system at the national level and affect the development of the real economy.

A comparison of Finland's and the other EU countries' systemic risks, based on indicators, provides strong justification for setting a systemic risk buffer requirement at a level of 1–3%. A quantitative overall assessment that the structural systemic risks of Finland's credit institutions sector are higher than in the 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 the other EU countries' indicators. In addition, the values of seven indicators are higher in Finland than the average of the 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 the 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.

Pursuant to the Credit Institutions Act, a further 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 have been deemed inadequate or unsuitable to ensure the sufficient capitalisation of credit institutions, and therefore they do not remove the need to impose a requirement concerning the systemic risk buffer:

- 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.

Maintaining the systemic risk buffer at the previously established levels means that, when the decision takes effect on 1 July 2020, the requirements for credit institutions do not change. Keeping the systemic risk buffer requirement unchanged is an effective and proportionate means to safeguard the credit institutions sector's risk absorbency and thereby to mitigate the impact of structural systemic risks and improve financial stability compared to an option in which the requirement is changed or removed.

Setting a systemic risk buffer requirement can be expected, via positive financial stability effects, to improve the functioning of the internal market and also to have a positive impact on the stability of other Member States, particularly those in which Finnish credit institutions have operations, and on the financial system of the European Union as a whole. Other impacts on the internal market or on foreign financial systems have been assessed to be minor.

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.

The justifications for the imposition of the systemic risk buffer for the entire credit institution sector 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 Nordea-group, OP 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.

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 tham those mentioned above (O-SII scores approximately: 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 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, Nordea group is the largest credit institution of the banking union countries.

Among the significant Finnish credit institutions, 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.

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.

Hence, on the basis of an overall assessment, the systemic risk buffer is proposed to kept unchanged at 3.0% for the Nordea Group and 2.0% for OP Financial Group. In addition, the systemic risk buffer for Municipality Finance Plc is proposed to be kept unchanged at 1.5% (contribution to systemic risk approximately 9%) and for other credit institutions at 1.0%, which is the lower limit for the systemic risk buffer.

As the requirements concerning the systemic risk buffer are kept unchanged, the capital requirements for credit institutions will not change when the decision becomes effective. Hence, the requirements to be imposed do not have a direct impact on the operation or capital requirements of credit institutions.

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. Compared to circumstances where no systemic risk buffers are in place and other capital requirements (incl. O-SII buffers) are at their present levels, the proposed systemic risk buffers would 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.

3.2 Additional capital requirements

According to the decision made by the Board of the FIN-FSA on 28 June 2019 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:

- 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, SBank 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 2020.