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 29 June 2018, the Board of the Financial Supervisory Authority has, in accordance with Chapter 10 Sections 4 and 6a of the Credit Institutions Act, decided on 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), in relation to the consolidated total risk exposure of the ultimate Finnish parent company of a consolidation group or an amalgamation of deposit banks, 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).

A condition for the decision to enter into effect as regards applying the systemic risk buffer to Nordea-group is that Sweden’s competent authority does not oppose the merger of Nordea Bank AB with Nordea Holding Oyj.

The decision of the Board on the systemic risk buffer will enter into effect on 1 July 2019.

Based on an analysis, the FIN-FSA considers that the structural systemic risks are currently so high in Finland’s financial system that it is justified to set a systemic risk buffer for all credit institutions. It is justified to set the requirement at a level of 1.0% for other credit institutions, but for Nordea-group 3.0%, for OP Group 2.0% and for Municipality Finance Plc 1.5% due to their greater importance than the others. If Nordea-group’s change of domicile is not realised, the requirement will be set in accordance with the decision for the other credit institutions that are subject to the decision.

Justifications for the decision

1 General justifications for setting a systemic risk buffer:

Finland’s financial system is structurally vulnerable, and the structural systemic risks favour the setting of a systemic risk buffer. The following structural risks constitute the main justification for setting a systemic risk buffer:

- Finland’s credit institutions sector is concentrated and, after the transfer of Nordea-group’s domicile, also large compared with 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 and
- The indebtedness of the largest borrowing sectors, particularly households, is high.

On the other hand, the interconnectedness of Finland's credit institutions sector via interbank deposits or its risk concentrations in domestic government bond exposures do not, on the basis of the analysis, represent major structural threats.

In addition, it should be taken into consideration that 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.

<u>2 Legislative justifications for setting a systemic risk buffer requirement of no more than 3%:</u>

According to Article 133 of the EU Capital Requirements Directive,[1] a Member State may introduce a systemic risk buffer of Common Equity Tier 1 capital for the financial sector or one or more subsets of that sector. The objective of the systemic risk buffer is to prevent and mitigate long-term non-cyclical systemic or macroprudential risks not covered by the

[1] Directive 2013/36/EU of the European Parliament and of the Council of 26 June 2013 on access to the activity of credit institutions and the prudential supervision of credit institutions and investment firms.

Capital Requirements Regulation that might have serious negative consequences to the financial system and the real economy in a specific Member State.

A condition of the application of the requirement, provided for in Chapter 10 Section 6a of the Credit Institutions Act (610/2014), is that the risk posed by long-term non-cyclical systemic or macroprudential factors threatening the financial system and the real economy requires a higher capital requirement and that this risk poses or might pose a threat at a national level to the smooth functioning and stability of the financial system. The structural systemic risks outlined above (in section 1) are used to estimate the higher capital requirement provided for in the said legal provision of the Credit Institutions Act. In addition, the risks pose or might pose, in the manner presented above, a threat at the national level to the smooth functioning and stability of the financial system.

In the light of the risk factors listed in the Credit Institutions Act and the indicators describing them, the structural systemic risks of Finland's credit institutions may be considered to be higher than the other EU countries on average, which provides justification, pursuant of the decree[2] supplementing the Credit Institutions Act (Section 3 Subsection 1), for setting a systemic risk buffer requirement at a level of 1–3%.

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 five indicators are higher in Finland than the average of the other EU countries' indicators, which also favours the overall assessment made.[3] 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 alongside the indicators when deciding on the requirements.

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[2] Ministry of Finance Decree (65/2018) on the additional capital requirement for credit institutions and investment firms imposed on the basis of the structural characteristics of the financial system (systemic risk buffer).

[3] In assessing the magnitude of the average systemic risk of the other EU countries, the mean is more susceptible than the median to the influence of individual countries' exceptional values of risk indicators. 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.

In addition, pursuant to the Credit Institutions Act, a condition 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 meeting the capital requirement. In accordance with the following considerations, it has been assessed that other available macroprudential instruments are not adequate or suitable to ensure the sufficient capitalisation of credit institutions and therefore do not remove the need to set a requirement for a 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 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.

In addition, on the basis of the impact assessment presented below, the Board of the FIN-FSA considers that the setting of a systemic risk buffer requirement 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 with an alternative option in which a requirement would not be set.

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.

<u>3 Justifications for imposing a systemic risk buffer of 1.0% on the whole credit institutions sector:</u>

A systemic risk buffer requirement can be imposed either on the whole credit institutions sector or only on some credit institutions. Different levels of systemic risk buffer can be imposed on different parts of the sector. The objective of the systemic risk buffer is to ensure that credit institutions have adequate capital requirements to cover structural systemic risks. The requirement should therefore be targeted at those credit institutions for which recognised systemic risks give rise to capital 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, irrespective of the size of credit institution. For a concentrated 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. The Board of the FIN-FSA therefore considers, deviating from the proposal, that it is justified to imposed a systemic risk buffer on the whole credit institutions sector in order to safeguard the adequate capitalisation of the sector.

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-2017) 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 Institution Act, the additional capital requirement must be reasonable and proportionate to the risk in question. In considering the additional capital requirements, the Board has underlined the vulnerability of the whole sector to systemic risk.

The systemic risk buffer requirement imposed on the whole credit institutions sector is considered to be justified and moderate, particularly in order that short-term effects that may potentially restrict lending do not form a barrier to continued economic growth.

With the justifications presented above, the Board of the FIN-FSA has decided, deviating from the proposal, to impose a systemic risk buffer requirement on the whole credit institutions sector at the minimum level according to the Act, i.e. 1.0%.

<u>4 Justifications for imposing a higher systemic risk buffer requirement on some credit institutions</u>

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.

In Finland, Nordea-group's contribution to structural systemic risks will be clearly the largest of the credit institutions after its transfer of domicile. OP Group's contribution is the second largest and also considerably larger than the other credit institutions. In addition, the risk-enhancing contribution of Municipality Finance Plc is to some extent larger than the other credit institutions.

As Nordea-group's and OP Group's significance for systemic risks is particularly high and their notional contribution to the indicators examined as justifications for the systemic risk buffer is also significant (according to an indicative estimate, Nordea-group's contribution is around 40% and OP Group's around 30%), it is justified, based on an overall assessment, to impose a systemic risk buffer of 3.0% on Nordea-group, in the situation following its transfer of domicile, and of 2.0% on OP Group. In addition, according to an indicative estimate, Municipality Finance Plc's contribution is larger, around 10%, than the other credit institutions, and therefore it is justified, in contrast with the other credit institutions, to impose on Municipality Finance Plc a systemic risk buffer of 1.5%.

In the case of Nordea-group, it is also justified to aim in the future at ensuring that the bank's current capital requirement corresponding to a binding 3.0% systemic risk buffer requirement, which has been imposed in Sweden, is maintained. On the other hand, the 2.0% additional capital requirement (so-called Pillar 2 requirement) imposed by the Swedish Supervisory Authority for macroprudential purposes is not binding in nature and does not, for example, limit the bank's dividend distribution opportunities. The decision has taken into consideration Nordea-group's establishment in the area of the banking union, the level of systemic risk buffer requirements set within the banking union, and the fact that the banking union reduces bank risks through joint supervision and resolution.

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-group. In other EEA countries, too, the systemic risk buffer requirements are 3% at most. 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. To ensure a fair operating environment in the banking union, it is, however, justified that the requirements set for Nordea-group do not deviate from the common line of the banking union or the other EU countries.

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.

In assessing the level of the systemic risk buffer requirement, the special preconditions set by the decree supplementing the Credit Institutions Act for imposing a systemic risk buffer of over 3% have also been taken into consideration. For a systemic risk buffer to be imposed above the 3% level, the systemic risk for Finnish credit institutions must, according to the decree, be significantly higher than the average systemic risk for the credit institutions of the other EU countries or the other euro area countries.

In the light of the indicators set out in the decree, justifications could also be presented for setting a systemic risk buffer of more than 3%, but the justifications are not as clear as the justifications for setting a requirement of 1–3%. The analysis based on the systemic risk indicators is founded on the assumption that the systemic risk significantly exceeds the corresponding systemic risk of the other EU countries if the value of an indicator in Finland is higher than the third quartile value for EU countries of an ordered list of indicator values (higher than 75% of the EU countries).

The imposition of a systemic risk buffer requirement of more than 3%, however, would require, in the view of the Board of the FIN-FSA, further analysis of the structural risks for Finland’s credit institutions sector.

With the justifications presented above, the Board of the FIN-FSA has decided, deviating from the proposal, that a systemic risk buffer of 3.0% be set for Nordea-group. The decision is conditional, and a condition for the decision to enter into effect is that Sweden’s competent authority does not oppose the merger of Nordea Bank AB with Nordea Holding Oyj.

As the Board, deviating from the proposal, imposes on Nordea-group a 3.0% and on other credit institutions a 1.0% additional capital requirement, it is also justified to change the additional capital requirements to be imposed on OP Group and Municipality Finance Plc from the proposal. In determining the levels of the 2.0% systemic risk buffer imposed on OP Group and the 1.5% systemic risk buffer imposed on Municipality Finance Plc, due consideration has been given to the greater significance than others of these credit institutions for the formation of systemic risk.

5 Justifications for applying the ”precautionary principle”:

As there are no actual and verified statistical data available on structural systemic risks in the new situation in which Nordea-group operates in Finland, it is justified that, at this stage, the systemic risk buffer requirement set for Nordea-group does not deviate significantly from systemic risk buffer requirements set within the banking union or the other EU countries.

In accordance with Chapter 10 Section 4 Subsection 3 of the Credit Institutions Act, 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 (systemic risk buffer), 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 Board of the FIN-FSA notes that the analysis to be made in 2019 relating to the level of systemic risk buffer requirements will be based on an actual situation in which Nordea-group's domicile is in Finland, and it may therefore be justified to deviate from the decision made now if actual statistical data provide grounds for doing so. The Board of the FIN-FSA also notes that calculations with respect to Nordea-group's contribution to systemic risk, for example, are based on estimates of the future and therefore involve greater uncertainty than calculations based on statistical data describing an actual situation.

6 Justifications for setting a systemic risk buffer requirement for total exposure:

The Board of the FIN-FSA considers that, in addition to risk concentrations, there are a number of other justifications for setting a systemic risk buffer requirement, and it is therefore justified to set the requirement for total exposure and not to restrict it merely to risk concentrations nor to items in Finland or in third countries.

7 Impact assessment of the system risk buffer requirement

The monetary amount for the whole credit institutions sector of the systemic risk buffer requirements according to the decision is approximately EUR 5 billion, estimated according to the 2017 total exposure of the credit institutions. It should be noted, however, that the change arising from the systemic risk buffer to the total amount of credit institutions' capital requirements will be significantly lower than estimated above because, in the case of the largest credit institutions, requirements of similar magnitude are already completely or partly in effect. A corresponding 3% systemic risk buffer requirement is currently imposed on Nordea-group in Sweden. In addition, it should be noted that with respect to the systemic risk buffer requirement (set for a credit institution's total exposure) and the additional capital requirement for global systemically important institutions (G-SII/B) or other systemically important credit institutions (O-SII), only the highest is obligatory. For this reason, in the case of the OP Group the imposition of a systemic risk buffer requirement does not change the total capital requirement because the O-SII requirement imposed on it is 2.0%. In the case of Municipality Finance Plc, the impact of the systemic risk buffer in increasing the capital requirement is 1.0%, consisting of the difference of the 1.5% requirement relating to the systemic risk buffer and the 0.5% O-SII requirement set for the credit institution.

The direct effects of the systemic risk buffer requirement on the capital requirements of Finnish credit institutions are considered to be minor. According to the assessment, the credit institutions will have no need to increase their capital adequacy ratio immediately in order to fulfil the requirement. It may be assumed, however, that the credit institutions 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 credit institutions and thereby their risk absorbency for structural systemic risks.

According to an analysis by a Ministry of Finance expert working group[4] that assessed the imposition of a systemic risk buffer, imposing a 1% requirement on most of the credit institutions 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 requirements according to the decision would increase the capital adequacy requirement of an individual credit institution by no more than one percentage point from the current level.

In accordance with Section 34 of the Administrative Procedure Act, the relevant credit institutions were given the opportunity to state their opinion on the matter and to give their explanation of any requirements or clarifications that might influence the deciding of the matter. The European Commission, the European Systemic Risk Board (ESRB), the European Banking Authority (EBA) and the relevant macroprudential and banking supervision authorities of EEA countries (Norway, Sweden and Denmark) have been notified of the decision in accordance with Article 133 of the Capital Requirements Directive.[5] The European Central Bank has been notified of the decision in accordance with Article 5 of the SSM Regulation.[6]

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[4] See Ministry of Finance expert working group report "Report on the necessity of introducing a systemic risk buffer requirement in Finland", Ministry of Finance publication – 4/2016 (in Finnish).
[5] Directive 2013/36/EU of the European Parliament and of the Council of 26 June 2013 on access to the activity of credit institutions and the prudential supervision of credit institutions and investment firms, amending Directive 2002/87/EC and repealing Directives 2006/48/EC and 2006/49/EC.
[6] 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.