

OP-Pohjola group's capital adequacy proven resilient in the European stress test exercise

The Committee of European Banking Supervisors (CEBS), in cooperation with the European Central Bank, the European Commission, and national supervisory authorities, coordinated an EU-wide forward-looking stress test of 91 banks in June–July. The test covers approximately 65% of the EU banking sector's total assets. The test sample was built by including key domestic banks, so as to cover at least 50% of the respective national banking sector, in terms of total assets. In Finland, the Financial Supervisory Authority (FIN-FSA), together with the Bank of Finland, was responsible for conducting the stress test exercise.

Of the Finnish banks, the stress test exercise included OP-Pohjola. In accordance with international guidelines, the scope of the exercise is banking operations, and thus the risks of insurance operations are excluded. The scope is in line with CEBS's mandate. FIN-FSA conducted the exercise in cooperation with OP-Pohjola, utilizing FIN-FSA's supervisory information.

Nordea Bank Finland, which is part of the Nordea Bank Group, and Sampo Bank, which is part of the Danske Bank Group, were also included in the stress test exercise as part of their parent groups. The home country supervisor's of the parent companies are responsible for supervising the stress test exercise on these groups and for publishing the groups' detailed results.

The EU stress test exercise covers approximately 82% of the Finnish banking sector's total assets.

In the exercise, the resilience of banks' capital adequacy was assessed, in scenarios which are based on the assumption of economic growth and shocks to the financial markets. The scenarios applied have been developed by CEBS, in cooperation with the European Central Bank and the European Commission. The scenarios describe unlikely, but plausible changes in banks' operating environment. The scenarios should not be taken as forecasts.

Common scenarios for all participants

The stress test exercise was based on the assumption that euro area economic growth will turn negative in 2010–2011, as a result of a global demand shock (adverse scenario). The scenario

also assumes negative developments in the financial markets, eg a decline in share prices and a rise in interest rates, particularly short-term interest rates. The stress test also addressed the impact of a market shock on European sovereign bond interest rates on losses recognised on banks' receivables. A benchmark scenario was also calculated within the test. The benchmark assumes a more favourable development of the operating environment than the adverse scenario does. This scenario should also not be taken as a forecast.

Based on the scenarios, CEBS differentiated key macroeconomic variables for European countries, with the exception of changes in commercial property prices, which are based on estimates by national authorities. CEBS also defined for both the scenarios key assumptions concerning capital markets, eg developments in share prices and interest rates. All the banks that participated in the test applied the same scenarios and variables of the operating environment CEBS provided, in their impact assessments. CEBS has sought to ensure the consistency of the stress test exercise by providing detailed calculation instructions (eg on the handling of credit risk parameters).

The stress test addressed impacts of the scenarios on trading book losses and losses on financial assets in the banking book, and the development of capital adequacy. Financial assets in the banking book include loans and receivables and other investments that are not held for trading. The assessment of developments in banks' income over the time horizon of the scenario was based on the assumption that the volume of business will not grow.

The market shock concerning the price of government debt was based on a scenario of negative growth, with includes a general rise in interest rates in 2010–2011. The shock is also based on the assumption that the market view of European governments' credit rating will deteriorate, which would widen the spreads relative to German government debt. The widening of spreads will decrease the market value of government bonds. CEBS defined the impact of the market shock on the different government bonds separately. For example, for Greek government bonds, an impairment loss of 23.1% was assumed as a result of the widening of spreads (haircut). All the parameters applied are available on CEBS's website.



Interest rate spreads between government bonds and the distribution of the bank's investments were used for calculating impairment losses on public sector receivables that are included in the bank's trading book, ie are recognised at fair value through profit or loss.

A further assumption was that an increase in a government's funding costs will also reflect negatively on the private sector credit ratings (ie corporate and retail exposures) of the country in question. Therefore, the test also included a calculation of additional losses on private sector exposures in the banking book, based on sensitivity data provided by CEBS.

In the assessment of the results of the stress test exercise, impairment loss calculated based on the sovereign shock was added to the losses estimated in the adverse scenario of the operating environment.

Stress test shows OP-Pohjola's capital adequacy is still significantly higher than the minimum target ratio

The results of OP-Pohjola group's banking business remains profitable in all parts of the exercise, and capital adequacy, as defined in the Credit Institutions Act, develops at a steady pace. The group's Tier 1 capital adequacy ratio, calculated on the basis of original own funds, is significantly higher than the international minimum target ratio (6%) of the test exercise. In addition, the total capital adequacy ratio remains significantly higher than the statutory minimum ratio of 4% in all parts of the tests.

In the adverse scenario, the Tier 1 ratio declines to 12.5% as risk-weighted assets grow in response to the deterioration of the lending stock. When the impact of the sovereign shock on impairment losses on financial assets is added to the scenario, the group's Tier 1 capital adequacy ratio declines to 12.3%. Thus, sovereign risk has only minor impact on the group's Tier 1 capital adequacy.

The stable development of OP-Pohjola's capital adequacy in the adverse scenario is based on the assumption of moderate risks of securities investments and positive developments in net

interest income as a result of a rise in interest rates in the stress scenario. Securities held for trading account for a small portion of financial assets in the banking book. Despite the assumption of zero growth, the group's net interest income starts growing, because the assumption of a rise in short-term interest rates has a positive impact on the net interest income.

Compared to the outturn in 2009, impairment losses (ie credit losses) on financial assets in the banking book in 2010 and 2011 grow considerably in both the scenarios. This is due to the unusually high loss assumptions applied in the stress text exercise, which particularly in the case of retail banking, result in significantly larger impairment losses than a year earlier. The values applied in the stress test can be considered as serious loss assumptions. For example in 2009, the ratio of impairments on retail receivables to retail exposures was 0.1%, compared to the adverse scenario under which the ratio is cumulatively in 2010–2011 a total of 0.98%, and with the impact of the sovereign shock at 1.15%.

Capital adequacy of the financial conglomerate also strong

The scope of the CEBS stress test exercise is banking operations, and the results described above have been calculated applying the same method as the other European banking groups. Therefore in the test, the financial conglomerate's capital adequacy under the Act on the Supervision of Financial and Insurance Conglomerates was not assessed. Capital adequacy under the Act on the Supervision of Financial and Insurance Conglomerates covers both the banking and insurance business of the conglomerate.

OP-Pohjola group's capital adequacy under the Act on the Supervision of Financial and Insurance Conglomerates was 1.62 at the end of March 2010 (statutory minimum 1.0), and the ratio of own funds surplus and the minimum requirement was EUR 2.3 billion. Considering the strong capital adequacy and the fact that the results remained positive in the test exercise, FIN-FSA and OP-Pohjola estimate that the capital adequacy of the financial conglomerate will also withstand the CEBS stress test scenarios very well.

Annex 1. CEBS stress test exercise scenarios: key variables for Finland

Benchmark Scenario	Finland	
	2010	2011
GDP at constant prices (% change y-o-y*, yearly average)	0.90%	1.60%
Unemployment (as % of the labour force, yearly average)	10.20%	9.90%
Short-term interest rates (3M) (Euribor or Libor depending on the country, yearly average)	1.20%	2.10%
Long-term interest rates (10y) yearly average	3.50%	3.90%
Commercial property prices (% change y-o-y*)	0%	0%
Residential property prices (% change y-o-y*)	0%	0%
Adverse Scenario	2010	2011
GDP at constant prices (% change y-o-y*, yearly average)	-0.10%	-0.60%
Unemployment (as % of the labour force, yearly average)	10.40%	11.40%
Short-term interest rates (3M) (Euribor or Libor depending on the country, yearly average)	2.10%	3.30%
Long-term interest rates (10y) yearly average	4.00%	4.60%
Commercial property prices (% change y-o-y*)	-10%	-10%
Residential property prices (% change y-o-y*)	-5%	-5%
Additional Sovereign shock on the Adverse Scenario	2010	2011
Long-term interest rates (5y) yearly average - Treasury bonds ¹	2.91%	4.16%

* y-o-y: year on year change

¹ including the widening of spreads relative to German government debt

Annex 2. Development of OP-Pohjola's result and capital adequacy in the stress text exercise

Actual results	
At December 31, 2009	EUR m
Total Tier 1 capital	5 227
Total regulatory capital	5 227
Total risk weighted assets	41 480
Pre-impairment income (including operating expenses)	764
Impairment losses on financial assets in the banking book	-180
Trading book losses	0
1 yr Loss rate on Corporate exposures (%) ¹	0.70%
1 yr Loss rate on Retail exposures (%) ¹	0.07%
Tier 1 ratio (%)	12.60%
Outcomes of stress test scenarios	
The stress test was carried out under a number of key common simplifying assumptions (e.g. constant balance sheet, uniform treatment of securitisation exposures). Therefore, the information relative to the benchmark scenarios is provided only for comparison purposes. Neither the benchmark scenario nor the adverse scenario should in any way be construed as a forecast.	
Benchmark scenario at December 31, 2011	EUR m
Total Tier 1 capital after the benchmark scenario	5 616
Total regulatory capital after the benchmark scenario	5 616
Total risk weighted assets after the benchmark scenario	41 797
Tier 1 ratio (%) after the benchmark scenario	13.40%
Adverse scenario at December 31, 2011	EUR m
Total Tier 1 capital after the adverse scenario	5 452
Total regulatory capital after the adverse scenario	5 452
Total risk weighted assets after the adverse scenario	43 758
2 yr cumulative pre-impairment income after the adverse scenario (including operating expenses) ²	1 169
2 yr cumulative impairment losses on financial assets in the banking book after the adverse scenario ²	-782
2 yr cumulative losses on the trading book after the adverse scenario ²	-36
2 yr Loss rate on Corporate exposures (%) after the adverse scenario ^{1, 2}	1.62%
2 yr Loss rate on Retail exposures (%) after the adverse scenario ^{1, 2}	0.98%
Tier 1 ratio (%) after the adverse scenario	12.50%
Additional sovereign shock on the adverse scenario at December 31, 2011	EUR m
Additional impairment losses on the banking book after the sovereign shock ²	-97
Additional losses on sovereign exposures in the trading book after the sovereign shock ²	-24
2 yr Loss rate on Corporate exposures (%) after the adverse scenario and sovereign shock ^{1, 2}	1.78%
2 yr Loss rate on Retail exposures (%) after the adverse scenario and sovereign shock ^{1, 2}	1.15%
Tier 1 ratio (%) after the adverse scenario and sovereign shock	12.30%
Additional capital needed to reach a 6 % Tier 1 ratio under the adverse scenario + additional sovereign shock, at the end of 2011	0

¹ Impairment losses as a % of corporate/retail exposures in AFS, HTM, and loans and receivables portfolios

² Cumulative for 2010 and 2011

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Annex 3. OP-Pohjola's banking book and trading book exposures to EEA30 central and local governments, at 31 March 2010, (EUR m)

	Gross exposures (less impairments)			Net exposures (less impairments)
		"of which Banking book"	"of which Trading book"	
Austria	0	0	0	0
Belgium	159	155	5	159
Bulgaria	0	0	0	0
Cyprus	0	0	0	0
Czech Republic	0	0	0	0
Denmark	0	0	0	0
Estonia	0	0	0	0
Finland	490	301	189	490
France	33	1	32	33
Germany	170	110	60	170
Greece	21	0	21	21
Hungary	0	0	0	0
Iceland	0	0	0	0
Ireland	41	41	0	41
Italy	7	0	7	7
Latvia	0	0	0	0
Liechtenstein	0	0	0	0
Lithuania	0	0	0	0
Luxembourg	0	0	0	0
Malta	0	0	0	0
Netherlands	2	0	2	2
Norway	0	0	0	0
Poland	0	0	0	0
Portugal	0	0	0	0
Romania	0	0	0	0
Slovakia	0	0	0	0
Slovenia	0	0	0	0
Spain	0	0	0	0
Sweden	96	96	0	96
United Kingdom	0	0	0	0