Decision of the Board of the Financial Supervisory Authority on the application of macroprudential instruments

At its meeting on 28 June 2023, the Board of the Financial Supervisory Authority (FIN-FSA) decided that the countercyclical capital buffer (CCyB) requirement, as referred to in chapter 10, section 4 of the Act on Credit Institutions (610/2014), will remain at 0.0% and that the period of validity of the decision on a lower maximum loan-to-collateral (LTC) ratio, taken on 28 June 2021 pursuant to chapter 15, section 11 of the Act on Credit Institutions, will be extended. With that decision, the maximum LTC ratio for new residential mortgage loans other than first-home loans was lowered by 5 percentage points, to 85%.

The Board of the FIN-FSA has also decided, in accordance with chapter 10, section 4 d of the Act on Credit Institutions to reciprocate the systemic risk buffer requirement of 3.5% imposed by the Norwegian macroprudential authority (Finansdepartementet) to be applied on Finnish credit institutions' balance sheet items and off-balance-sheet commitments located in Norway. The requirement applies to credit institutions whose risk-weighted exposures in Norway exceed 5 billion Norwegian krone. Due to the overlap of the risks covered by the Norwegian systemic risk buffer requirement and Finland's national systemic risk buffer requirement (the requirements are concerned with the same exposures), pursuant to chapter 10, section 9(3) of the Act on Credit Institutions, credit institutions must only meet the higher of these requirements. The requirement will enter into force on 1 July 2024.

In addition, pursuant to chapter 10, section 8 of the Act on Credit Institutions, the FIN-FSA has reviewed the additional capital requirements applicable to other systemically important institutions (O-SII) set by the FIN-FSA Board on 27 June 2022. In the review, no grounds have emerged to adjust these capital requirements, and therefore, no new decision was made in the matter.

Justifications for the decision

Countercyclical capital buffer requirement

The financial cycle has deteriorated further, and based on the indicators, risks of overheating in the financial system appear limited. The primary risk indicator, the credit-to-GDP gap, stood at –20,6 percentage points at the end of March based on preliminary data. The growth of household loans and the private-sector loan stock as a whole relative to nominal GDP has been sluggish. The stress index for the financial sector rose in March due to financial market turbulence and decreasing bank stock prices, but it has declined since then.

Among the risk indicators, only current account deficit, which indicates the external balance of the economy, signals increased vulnerabilities. The historically large current account deficit in 2022 is partly explained by an increase in the value of goods imports due to higher energy prices. The composite indicator of the current account deficit and the credit-to-GDP ratio does not imply causality between the credit cycle and the current account deficit.

Neither do other supplementary risk indicators point to an overheating in the credit cycle. According to the most recent observations, real house prices have declined throughout the country. The growth of the balance sheet of the banking sector relative to GDP has slowed down. Hence, an overall assessment based on the risk indicators used does not support the application of a countercyclical capital buffer requirement.

Maximum loan-to-collateral ratio

Developments in the housing markets at the beginning of 2023 continued in the same vein as at the end of 2022. The downturn has not deepened or eased materially from the previous months. House sales in January–April remained clearly lower than in previous years. Nominal house prices declined in April 2023 year-on-year and were lower than at the end of 2022 on average across the country. The number of dwellings for sale in May increased year-on-year, and their selling times were clearly longer than a year earlier.

In April 2023, the housing loan stock was slightly smaller than at its peak in September 2022. At the beginning of the year, households drew down clearly fewer housing loans than a year earlier. It is estimated that households have mostly continued to amortise their loans regularly. However, the rise in interest rates may have reduced the monthly amortisation amount in most loans. In addition, the use of grace periods may have become more common, but there are no indications of any widespread use.

House sales tend to pick up in the spring, but so far there has been no rapid and strong recovery, due to an increase in loan interest rates, among other things. An increase in interest rates tends to reduce borrowing. Towards the end of 2022 and in the first quarter of 2023, households drew down fewer housing loans, and on average in lower amounts, than just a year earlier.

Other characteristics and terms of new housing loans developed at the end of 2022 and early 2023 along the same lines as in previous quarters. In the first quarter of 2023, the proportion of loans with the highest LTC ratios (over 90% for first-home loans and over 80% for other loans) was slightly lower than in the previous quarter and a year earlier. The proportions of loans longer than 26 years and 30 years stood at record highs at the beginning of 2023, however, in particular, the proportion of loans longer than 30 years decreased in April.

Households' historically high housing and overall indebtedness relative to disposable income has been identified as a key structural vulnerability of the financial system for a long time, and the situation is not anticipated to change materially in the near future. The protracted growth of household indebtedness turned into a slight decline in the latter half of 2022 and continued during the first quarter of 2023. Nevertheless, household indebtedness remains at a historically high level and clearly higher than in 2007–2008 – the last time when interest rates rose and were higher than at present. Households are expected to cope with their debts but save on consumption if necessary. The situation of households and likewise of the construction industry involves risks that cause the prospects of the housing markets to remain very uncertain.

In setting the maximum LTC ratio, attention must also be paid to the development of cyclical risks to financial stability, which depend, among other things, on the cyclical situation of the economy and of the housing loan markets. A significant dampening of the housing markets and lending would support bringing the maximum LTC ratio back to its statutory baseline level. A smaller equity funding proportion (larger housing loan relative to collateral) could contribute to supporting financial intermediation and the operation of the housing markets, which could mitigate, to some extent, an adverse contraction of house sales, consumption and economic activity as a whole.

On the other hand, the prospects of the housing markets continue to involve high uncertainty, and economic risks remain on the downside. If the downside economic risks were to materialise, they would further dampen the outlook of the housing markets and erode households' loan-servicing and consumption capacity compared to the estimates. As opposed to lowering the maximum LTC ratio, keeping it at its present level would better ensure that new mortgage borrowers have adequate financial buffers for the event of weaker economic developments and a decline in collateral values.

From a cyclical perspective, the upside risk should also be taken into account that normal housing demand that becomes pent up during a recession and times of high economic uncertainty may be unwound even rapidly if the recession remains mild and short-lived, and caution in the housing markets decreases. In the past, such rapid recoveries have been supported by interest rates declining steeply (during the global financial crisis) or remaining at a low level (during the COVID-19 pandemic). The impact of the maximum LTC ratio on the demand for housing and housing loans is estimated to be minor in circumstances characterised by very weak consumer confidence in the economy. The impact could be larger once the economic uncertainty has waned.

The development of residential mortgage lending also reflects the recommendation of the FIN-FSA Board on a maximum debt-servicing burden for housing loan applicants that entered into force at the beginning of 2023 and the statutory limits for the maximum length of residential mortgage loans and for the maximum length and amount of housing company loans entering into force at the beginning of July 2023. In addition, the maximum LTC ratio will be extended to also cover new housing loans potentially granted by other lenders than credit institutions. These measures are estimated to be either neutral or have a slightly tightening impact on lending, thereby reducing the need for a more stringent maximum LTC ratio than the baseline level. On the other hand, keeping the maximum LTC ratio at its current level will curb excessive household indebtedness and strengthen borrowers' financial buffers similarly to the measures stated above.

In addition, keeping the maximum LTC ratio unchanged can also be regarded as consistent with the current monetary policy objectives. If the maximum LTC ratio were adjusted in an attempt to boost lending and the accumulation of debt in an environment of rapid inflation and weakening economy, this would not be in line with current monetary policy.

Due to the uncertainty associated with the prospects of the economy and the housing markets, there remains a need to prevent the growth of vulnerabilities related to high household indebtedness and to ensure the risk resilience of new borrowers. Hence, the FIN-FSA Board's decision of June 2021, effective in October, to adjust the maximum LTC ratio to 85% for new residential mortgage loans other than first home loans remains justified in terms of curbing the number of large housing loans in relation to collateral and ensuring the resilience of new borrowers. The maximum LTC ratio for first home buyers also remains unchanged.

Reciprocation of the Norwegian systemic risk buffer requirement

Background – In December 2020, Finansdepartementet, the Norwegian Ministry of Finance functioning as the macroprudential authority, , decided to impose a 4.5% systemic risk buffer requirement on credit institutions' Norwegian exposures.

In June 2021, the European Systemic Risk Board (ESBR) published a recommendation on the application of the measures on EEA member states' credit institutions as regards their exposures located in Norway.[1] The ESRB recommended that the EEA member states adopt the measures. It was stated in the Recommendation that before the Norwegian legislation has been amended in accordance with the new EU Credit Requirements Directive (CRD V), the systemic risk buffer requirement could be adopted in a way that takes account of any overlap or difference in the capital requirements applicable in Norway and other EEA countries.

In August 2021, in connection with the adoption of the Norwegian risk weight floors, the FIN-FSA Board stated that a decision on the adoption of the Norwegian systemic risk buffer requirement could not be made yet, since Norway applies the earlier version of the EU's Capital Requirements Regulation (CRD IV) and Finland applies the updated CRD V.[2] It was seen as a problem that the Norwegian systemic risk

1 https://www.esrb.europa.eu/pub/pdf/recommendations/2030/esrb.recommendation300430_amending_recommendation_esrb20152_on_the_assessment_of_cross-border_effects_of_and_voluntary_reciprocity_for_macroprudential_policy_measures~76f67e3de0.en.pdf

2 https://www.finanssivalvonta.fi/globalassets/fi/markkinoiden-vakaus/makrovakaus/mv_19082021/decision_en_19082021.pdf

buffer requirement was justified partly with risks that relate to the systemic importance of individual institutions and which, under CRD V, should be solely covered by O-SII buffers. Therefore, the FIN-FSA Board concluded that a final decision on the application of the systemic risk buffer requirement to Finnish credit institutions would be taken only when there is adequate information on the transposition of the currently applied EU directive on credit institutions (CRD V) into Norwegian legislation and on how the related legislative changes and the requirements of the Directive are taken into account in the rationale for setting and calibrating the Norwegian systemic risk buffer requirement.

The EU’s current Credit Requirements Directive (CRD V) was transposed into Norwegian legislation in June 2022. Finansdepartementet updated its decision on the systemic risk buffer requirement in accordance with the updated legislation on 16 December 2022 and notified the authorities of the EEA countries thereof.[3] Hence, the conditions of the FIN-FSA Board’s decision for the reciprocation of the systemic risk buffer requirement have been fulfilled as a result of Norway’s new legislation and the updated decision on the requirement taken in December.

In its decision of August 2021, the FIN-FSA Board stated that the FIN-FSA, as a rule, adheres to the ESRB’s recommendation on the reciprocation of the systemic risk buffer requirement. The Board found that reciprocation is justified, as a rule, to strengthen the effectiveness of macroprudential policy and promote a level playing field.

Finansdepartementet’s notification – In its notification of December 2022, Finansdepartementet justifies the setting of a systemic risk buffer requirementin particular by i) household indebtedness, ii) banks’ substantial exposure to commercial real estate and iii) the interconnectedness of banks’ funding. These primary justifications of the requirement can be regarded as structural vulnerabilities affecting the whole credit institution sector. The risks have remained unchanged since the previous decision of December 2020. The present decision makes reference, in addition to the abovementioned justifications, to the importance of the banking sector for the economy and to the concentration of the banking sector. These latter justifications are similar in nature to the justifications for setting additional buffer requirements to other systemically important institutions (O-SII), but they do not, however, constitute relevant grounds for setting a systemic risk buffer requirement. In its notification, Finansdepartementet emphasises that the focus of the systemic risk buffer requirement is a more inherent systemic risk within the entire banking system, whereas the O-SII assessments are concerned with significant risks associated with individual banks, and furthermore, that the level of Norwegian O-SII buffers is taken into account when assessing the need for a systemic risk buffer requirement. In conclusion, the Finansdepartementet finds that, due to the above considerations, the systemic risk buffer

[3] https://www.regjeringen.no/contentassets/451c80afb04d47fcb959596b79bbb7b8/syrb-template-esrb.pdf

requirements are not duplicating the O-SII buffers, even if both requirements are concerned with elements of concentration risk.

According to an assessment by Finansdepartementet and an analysis by the Norwegian central bank (Norges Bank), a 4.5% systemic risk buffer requirement is sufficient to restrict and prevent the abovementioned risks.[4] The materialisation of the risks could have a considerably negative effect on Norway's financial system and real economy.

ESRB's measures – The ESRB has assessed the justifications of Norway's previous systemic risk buffer requirement based on a notification made by Finansdepartementet in September 2022 concerning O-SII capital requirements. The notification was made because the sum of the systemic risk buffer requirement and the O-SII requirements applicable to certain systemically important credit institutions in Norway is higher than 5.0%, which, in accordance with CRD V, requires adoption by EU/EEA authorities. In December 2022, the Standing Committee of the EFTA States authorised combined amount of the requirements in excess of 5.0%, based on the ESRB's favourable opinion.

In response to the notification made by Norway in December 2022, on 13 April 2023, the ESRB published its updated recommendation on the application of the systemic risk buffer requirement to EEA credit institutions regarding their exposures located in Norway.[5] In its recommendation, the ESRB recommends the adoption of the Norwegian systemic risk buffer requirement of 4.5% by the EEA countries without a new transition period.

FIN-FSA's view – The FIN-FSA finds that Finansdepartementets notification sets out the justifications for setting the systemic risk buffer requirement in detail as required in Article 133(9) of CRD V and that it includes the information specified in Article 133(13), which have been considered by the FIN-FSA.

According to the notification, the primary justifications for setting the systemic risk buffer requirement are household indebtedness, banks' significant exposures to commercial real estate and the interconnectedness of banks' funding. Overall, systemic risks are at the same level as in 2020 when the previous decision on the systemic risk buffer requirement was made. According to the notification, household indebtedness is, similarly to the previous decision, at a historically high

[4] https://www.norges-bank.no/en/news-events/news-publications/Submissions/2022/2022-11-07-systemic-risk-buffer/. See also Finanstillsynet's statement https://www.finanstilsynet.no/contentassets/001c00a1f734431d92978f1bed3dc3e2/vurdering-av-nivaet-pa-systemrisikobuffersatsen.pdf

[5] https://www.esrb.europa.eu/pub/pdf/recommendations/esrb.recommendation230306_amending_recommendation_esrb20152_on_the_assessment_of_cross-border_effects_of_and_voluntary_reciprocity_for_macroprudentia~f487368685.en.pdf?28f751615e4b615cfa7bbdb3368c8af8

level, which makes households vulnerable to loss of income, higher interest rates or a fall in house prices. If many households reduce consumption at the same time, according to the notification, this will impair firms' earnings and the value of banks' corporate exposures, constituting a risk to the Norwegian financial system and economy.

According to the notification, banks' exposures to commercial real estate account for around half of the corporate sector's total loan stock. In previous crises, a significant proportion of losses incurred by credit institutions has stemmed from exposures to commercial real estate. Commercial real estate exposures as a proportion of Norwegian credit institutions' total corporate credit have remained stable in recent year.

In addition, according to the notification, covered bonds issued by Norwegian credit institutions make up a significant proportion of credit institutions' liquid assets. Cross-holdings of bonds increase interconnectedness among credit institutions, which makes the credit institution sector particularly vulnerable in the event that the risks materialise. According to the notification, there is a risk of forced sales and impairments of covered bonds, and thereby a deterioration of the liquidity position of credit institutions if, for example, the Norwegian housing markets or individual credit institutions were to face a significant crisis that triggers a significant increase in the risk premia on covered bonds. According to the notification, the amounts of covered bonds held by credit institutions have remained unchanged, but as a proportion of credit institutions' liquidity reserve, they have decreased in recent years.

The justifications of the notified decision on the systemic risk buffer requirement make reference, in addition to the abovementioned justifications, to the importance of the banking sector for the economy and to the concentration of the banking sector.

According to the notification, the 4.5% systemic risk buffer requirement set by Norway's Finansdepartementet strengthens the loss-absorbing capacity of the country's credit institution sector and thereby the structural stability of the entire national financial system. The more detailed effects of the systemic risk buffer requirement are indicated in section 4.4 of the notification.

The reciprocation of the systemic risk buffer requirement in those EEA countries (incl. Finland) whose credit institutions have exposures in the Norwegian market strengthens the capacity of these credit institutions to bear the risks associated with the Norwegian markets in accordance with the notification and the ESRB Recommendation.[6]

[6] Furthermore, the Memorandum of Understanding concluded by the central banks of Sweden, Norway, Denmark and Finland as well as the European Central Bank in 2016 (p. 16–17) emphasises the importance of reciprocal adoption of macroprudential tools to ensure financial stability and a level playing field. https://www.finanssivalvonta.fi/globalassets/fi/finanssivalvonta/linjaukset/kv.-yhteistyo/mou_on_prudential_supervision_of_significant-branches.pdf

As regards the applicability of macroprudential tools other than the systemic risk buffer requirement to structural risks belonging to the scope of the systemic risk buffer requirement, the FIN-FSA finds that macroprudential supervision measures applied in Norway and Finland to borrowers primarily affect new contracts (new lending business), and therefore do not prevent or limit structural risks or vulnerabilities associated with existing contracts.

The countercyclical capital buffer requirement is intended to limit the cyclical systemic risks caused by the rapid growth of lending to the private sector and its consequences; therefore, it is not suitable for a reduction of systemic risks caused by the typically long-term structural vulnerabilities of the banking sector.

The purpose of the risk-weight floors applied in Norway on residential and commercial real estate loans is to prevent an excessive decline of risk weights relative to the risks, which does not correspond to the objective of the systemic risk buffer requirement.

Supervisory measures available to the supervisory authority can be used to impose requirements on credit institutions for example to cover their institution-specific risks and to rectify shortcomings pertaining to their operations (so-called Pillar 2 requirement), but they are not primarily intended for limiting systemic risks to financial stability. Neither are available liquidity requirements primarily intended for limiting identified systemic risks to financial stability.

In the FIN-FSA's opinion, the Norwegian systemic risk buffer requirement is mainly based on other risks as required by CRD V than those used as the criteria for Finnish credit institutions' O-SII requirements. The O-SII requirements set by the FIN-FSA in accordance with chapter 10, section 8 of the Act on Credit Institutions cover the risks resulting from the systemic significance of individual credit institutions for the financial system. According to Norway's notification, the primary criteria for setting the systemic risk buffer requirement are the indebtedness of Norwegian households, banks' significant exposures to commercial real estate and the interconnectedness of banks' funding. In other words, these are systemic risks posed by the entire financial system to individual credit institutions. In the Norwegian Finansdepartementet's view, there is no overlap with the O-SII requirements. The ESRB also states in its Recommendation (par 12) that no evidence has been found of any overlaps between the Norwegian systemic risk buffer requirement and the O-SII requirements in terms of risks.

Pursuant to chapter 10, section 8(5) of the Act on Credit Institutions, the risk criteria of the credit institution-specific O-SII requirements are as follows: i) size of a credit institution measured by its total liabilities or the balance sheet total or consolidated balance sheet total; ii) liabilities of a credit institution and undertakings within its consolidated supervision to other credit institutions and receivables from other credit institutions as well as other immediate connections with the financial system; iii) substitutability of the critical functions of a credit institution and undertakings within its consolidated supervision after the undertaking lost its prerequisites to continue its operation; iv) extent and significance of cross-border operations of a credit institution and undertakings within its consolidated supervision in Finland and in the European Economic Area.

The third primary risk criterion referred to in the notification (interconnectedness) partly corresponds to the second risk criterion of the O-SII requirements (receivables of the credit institution from other credit institutions and liabilities to other credit institutions). The interconnectedness of Finnish credit institutions with the rest of the financial system is reviewed as part of the assessment of the systemic importance of credit institutions and the determination of O-SII buffer requirements. Debt securities issued by Finnish credit institutions and holdings of debt securities issued by other credit institutions, such as covered bonds, increase the interconnectedness of credit institutions for the purposes of calculation of O-SII scores and thereby also justify the application of higher O-SII buffer requirements. Therefore, interconnectedness as one of the primary risk criteria underlying the Norwegian systemic risk buffer requirement can be considered partly overlapping with Finnish credit institutions' O-SII buffer requirements.

The significance of the third risk criterion of the systemic risk buffer requirement (interconnectedness) for the Finnish banking sector is more minor than for credit institutions registered in Norway. Covered bonds issued by Norwegian credit institutions account for approximately 4% of Finnish credit institutions' total liquid assets and approximately 16% of covered bonds eligible for meeting the liquidity coverage requirement. For example according to data published by Norges Bank, this proportion is considerably higher for Norwegian banks.[7]

The notification states that, in setting the Norwegian systemic risk buffer requirement, the O-SII requirements for three Norwegian credit institutions were taken into account to ensure that there would be no duplication of capital requirements in terms of covering operational concentration risk. Hence, the assessment of duplication between concentration risk and the O-SII requirements in the notification does not extend to foreign credit institutions operating in Norway.

In Finland, risks related to concentration are protected in accordance with the Act on Credit Institutions and the Capital Requirements Directive solely with O-SII buffer requirements, which are concerned with credit institutions' all assets. In calculating the O-SII scores indicating systemic importance, the entire balance sheet of Finnish credit institutions is taken into account. Therefore Finnish credit institutions' functions in Norway also contribute to their systemic importance assessed in terms of O-SII scores and accordingly to their O-SII buffer requirements in Finland. Therefore, high concentration of the banking sector cited as a secondary criteria underlying the

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[7] See for example Norges Bank (2022) [Financial Stability Report]

Norwegian systemic risk buffer can be considered partly overlapping with the criteria for determining Finnish credit institutions' O-SII buffer requirements.

According to the notification, the stress test used in determining the level of the systemic risk buffer requirement of 4.5% does not account for branches of foreign credit institutions.

In conclusion, the FIN-FSA finds that reciprocation of the Norwegian systemic risk buffer requirement will prevent and reduce risks to the stable operation of the financial system and the real economy. The risk caused by long-term non-cyclical factors to the financial system or the macroeconomy calls for a higher capital requirement, as stated in the Finansdepartementet's notification. The risks to stability indicated by Finansdepartementet are also significant on a stand-alone basis. The risk threatens or may threaten the smooth operation and stability of the financial system also in Finland, and the adoption of the additional capital requirement does not have other than minor negative effects on the operation of financial systems in other countries.

In the FIN-FSA's view, it cannot be excluded that there is partial overlap between some of the criteria for the determination of the Norwegian systemic risk buffer requirement and the O-SII buffer requirements (interconnectedness, concentration). Furthermore, the assessment of the overlap between concentration risk and O-SII requirements has not been extended to foreign credit institutions operating in Norway, and the stress test applied in determining the 4.5% level of the Norwegian systemic risk buffer requirement does not consider branches of foreign credit institutions, which increases uncertainty regarding the proportionality of the requirement from the perspective of Finnish credit institutions. In light of the above, the FIN-FSA finds that, observing the prudence principle, it would be warranted to adopt the Norwegian systemic risk buffer requirement for Finnish credit institutions partially so that the level of partial adoption is at least two-thirds of the original level of the Norwegian systemic risk buffer requirement. In light of the abovementioned considerations, the FIN-FSA finds that the appropriate level of application is 3.5%.

The Norwegian systemic risk buffer requirement will enter into force and apply to Finnish credit institutions on 1 July 2024. The transition period is consistent with the previous decision of the FIN-FSA Board and the 12-month transition period under Finland's national legislation for the entry into force of a systemic risk buffer requirement. The notification states that the phasing-in period of the systemic risk buffer requirement applicable to Norwegian credit institutions not using the advanced IRB approach to the assessment of credit risk has been extended to 31 December 2023. The reason for the solution is the reassessment of Pillar 2 requirements in 2023. Other Norwegian credit institutions are not subject to the phasing-in period.

In accordance with the Finansdepartementet's decision, the systemic risk buffer requirement applies to credit institutions whose risk-weighted exposures in Norway exceed 5 billion Norwegian krone.

Due to the partial overlap of the risks covered by the Norwegian systemic risk buffer requirement and the Finnish systemic risk buffer requirement, i.e. the requirements are concerned with the same exposures, credit institutions must only meet the higher of these requirements (chapter 10, section 9(3) of the Act on Credit Institutions). Hence, the net impact of the Norwegian systemic risk buffer requirement is the Norwegian systemic risk buffer requirement partially reciprocated by the FIN-FSA (3.5%) less 1.0 percentage point for exposures in located Norway.

In connection with its decision regarding the domestic systemic risk buffer requirement, the FIN-FSA has assessed the impact of future additional capital requirements on the amount of Finnish credit institutions' own funds in excess of prudential requirements and thereby on their lending capacity.[8] The assessment assumed that the Norwegian risk buffer requirement would be reciprocated in full to apply to Finnish credit institutions' Norwegian exposures. According to the impact assessment, the upcoming macroprudential buffer requirements would not significantly impair Finnish credit institutions' lending capacity. The partial reciprocation of the Norwegian systemic risk buffer requirement further reduces these estimated risks.

The partial application of the Norwegian systemic risk buffer requirement to Finnish credit institutions increases the aggregate capital requirement of the Finnish credit institution sector by an estimated 0.3 percentage points of risk-weighted assets. The average risk weights of Finnish credit institutions applying internal prudential calculation models are typically lower than those of credit institutions applying the standardised approach. The level of the applied risk weights in turn determines the impact of the Norwegian systemic risk buffer requirement on each credit institution in euro terms.

According to Bank of Finland calculations, the partial reciprocation of the Norwegian systemic risk buffer requirements, the tightened O-SII requirements that entered into force at the beginning of 2023, the countercyclical capital buffer requirements imposed by other Nordic countries and the domestic systemic risk buffer taking effect at the beginning of 2024 would not have significant impacts on the real economy.[9] In the medium term, the increase in prudential requirements reduces the annual total output level by approximately 0.2%. According to the model, the change in the requirements does not have an effect on

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[8]https://www.finanssivalvonta.fi/contentassets/84ea9cf01a5d4f7f96a506311d71343d/mv_29032023/jk_paatos_makrovakausvalineet_29032023_en.pdf (pages 15–18) and https://www.finanssivalvonta.fi/contentassets/84ea9cf01a5d4f7f96a506311d71343d/mv_29032023/liite_maaraamisen_perusteet_indikaattorit_julkaistavat_tiedot_en.pdf (pages 20–23).

[9] The calculations have been made using the Bank of Finland's dynamic stochastic general equilibrium model Aino 3.0. In the calculations, the average prudential requirements for the Finnish banking sector are assumed to grow by approximately 1.9 percentage points.

long-term growth. Overall, the estimated impacts on economic growth, consumption and investments are very small.

In research literature, strong capital adequacy of the credit institution sector has been found to reduce the probability of banking crises.[10] The societal benefits of prudential requirements are estimated to be higher than their costs, also at higher levels of prudential requirements than those applied in Finland. In research literature, strong capital adequacy has also been found to reduce the risk of severe economic recessions.[11] Recovery from banking crises is also faster and the costs of recession remain considerably lower if the credit institution sector is financially sound at the onset of the crisis.[12]

Responses to the hearing – In a hearing under section 34 of the Act on Credit Institutions addressed at credit institutions, Nordea Bank Abp submitted a written response to the FIN-FSA. The response dated on 26 May 2023 also includes a separate report on the impact of credit institutions' capital requirements on bank lending margins and an opinion by Professor Vesa Puttonen. The FIN-FSA Board has taken into account the considerations presented in the response in its decision making regarding the reciprocation of the Norwegian systemic risk buffer requirement.

In its response, Nordea Bank Abp states it objects to the FIN-FSA Board's planned decision on the reciprocation of the Norwegian systemic risk buffer requirement. According to Nordea Bank Abp, the hearing letter provided to it does not meet statutory requirements for a hearing letter, and as a result, Nordea Bank Abp is unable to comment on the planned decision in a manner required by law. The information provided is not fully consistent with the requirements of the Ministry of Finance Decree (409/2021). The FIN-FSA Board should refrain from taking a decision on the reciprocation of the Norwegian systemic risk buffer requirement until Nordea Bank Abp has been provided the information required by the Administrative Procedure Act on the planned decision. Furthermore, according to Nordea Bank Abp, the FIN-FSA has not analysed the impacts of the reciprocation of the Norwegian systemic risk buffer requirement on the operation of credit institutions and the national economy.

According to Nordea Bank Abp, the micro- and macroprudential capital requirements applied to it at present cover all risks indicated in Finansdepartementet's notification. The risks stated in the notification are primarily concerned with high household indebtedness, the amount of credit institutions commercial real estate credit and the

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[10]See for example Basel Committee on Banking Supervision (2019), The cost and benefits of banking capital – a review of the literature. *BIS Working Paper 37*.
[11] See for example Boyarchenko, Giannone & Kovner (2022), Bank capital and real GDP growth. *Federal Reserve Bank of New York Staff Reports NO. 950*; Budnik, Dimitrov, Giglio, Groß, Lampe, Sarychev, Tarbé, Vagliano & Volk (2021), The growth-at-risk perspective on the system-wide impact of the Basel III finalization in the euro area. *EBB Occasional Paper Series No 258.*
[12] See for example Jórda, Richter, Schularick, & Taylor (2021), Bank capital redux: Solvency, liquidity, and crisis. *Review of Economic Studies 88.*

interconnectedness of credit institutions' funding, and secondarily the role of credit institutions in the financing of households and companies as well as the concentration of the credit institution sector. According to Nordea Bank Abp, no quantitative analysis proving that the micro and macroprudential capital requirements would not cover all risks stated in Finansdepartementet's notification, has been presented to Nordea Bank Abp. In its decision on the reciprocation of the Norwegian systemic risk buffer requirement, the FIN-FSA Board should consider all existing micro and macroprudential capital requirements.

In addition, according to Nordea Bank Abp, the risks stated in Finansdepartementet's notification are not relevant from Nordea Bank Abp's point of view, and no quantitative analysis providing their relevance has been presented to Nordea Bank Abp. Reciprocation of the Norwegian systemic risk buffer requirement would compromise the level playing field for credit institutions. The fact that Nordea operates within the European banking union, where supervision is centralised under the European Central Bank (Single Supervisory Mechanism, SSM) and where there is a common Single Resolution Mechanism (SRM), reduces risks and supports the grounds for lower capital requirement levels, according to Nordea Bank Abp.

According to Nordea Bank Abp, there are overlaps between the risks related to the Norwegian systemic risk buffer requirement and the additional capital requirements applicable to other systemically important institutions (O-SII). The high volume of household and commercial real estate credit is correlated with the indicator for the size of credit institutions considered in the O-SII criteria. At the same time, the interconnectedness of credit institutions' funding is considered in the O-SII interconnectedness criterion, and concentration is also also one of the application criteria for the O-SII criteria. Norwegian authorities have partly acknowledged the overlap between the Norwegian systemic risk buffer requirement and the Norwegian O-SII requirements by taking the systemic risk buffer requirement into account in setting the O-SII requirements. According to Nordea Bank Abp, Finansdepartementet's justifications as to why there is not overlap are inadequate. According to Nordea Bank Abp, there is also a similar overlap of risks between the Norwegian systemic risk buffer requirement and Finnish O-SII requirements. The claim that the systemic risk buffer requirement covers risks caused by the financial system to individual credit institutions while O-SII requirements cover risks caused by an individual credit institution to the system is neither based on the law nor justifiable in any other way either. Nordea Bank Abp also sees an overlap of risks between the Norwegian and Finnish systemic risk buffer requirements.

According to Nordea Bank Abp, the stress test used as the basis for the determination of the level of the Norwegian systemic risk buffer requirement only applied to the largest Norwegian credit institutions, and did not include Nordea Bank Abp or its subsidiaries. Therefore the results of the stress tests are not applicable to Nordea Bank Abp, whose risk weights and structure of operations are different from Norwegian credit institutions.

FIN-FSA's assessment of the responses – The FIN-FSA finds that the hearing concerning the reciprocation of the Norwegian systemic risk buffer requirement was carried out in accordance with section 34 of the Administrative Procedure Act. Section 4 d of the Act on Credit Institutions, which provides on the reciprocation of another EEA member state's systemic risk buffer requirement, does not contain a reference to the Ministry of Finance Decree (409/2012) or provide the power to issue a decree. In its decision, in accordance with Article 134(3) of the Credit Requirements Directive (CRD V), the FIN-FSA has considered the information referred to in Article 133, paragraphs 9 and 13 presented by the member state which set the systemic risk buffer requirement.

The micro- and macroprudential capital requirements currently applicable to Nordea Bank Abp are based on valid national and EU regulation. The decision on the reciprocation of the Norwegian systemic risk buffer requirement provides explanations as to why the risks for which the Norwegian systemic risk buffer requirement was set have not been covered by other additional capital requirements.

National and EU regulation concerning credit institution activities establish a level playing field for credit institutions operating in the EEA.

In its decision making, the FIN-FSA assesses the impacts of its decisions on the operation of credit institutions, the stability of the financial system and the national economy, where relevant. Similarly to the justifications for this decision, assessments concerning the impacts on credit institutions are usually quantitative while the assessments of impacts on financial stability and the economy in more general terms tend to be qualitative. Regulation concerning the FIN-FSA's activities does not include an obligation to conduct quantitative impact assessments. The macroeconomic impacts of upcoming capital requirements applicable to Finnish credit institutions have been reviewed above in connection with the decision on the reciprocation of the Norwegian systemic risk buffer requirement.

Pursuant to chapter 10, section 4 b (1) of the Act on Credit Institutions, a systemic risk buffer may be imposed to prevent and mitigate risks with an adverse effect on the stable operation of the financial system or the real economy. The systemic risk buffer requirement prevents and mitigates general risks in the financial markets (affecting all institutions). For example, O-SII buffer requirements prevent and mitigate risks associated with individual institutions. Hence, the application criteria of the systemic risk buffer requirement do not directly support Nordea Bank Abp's claim that the risks underlying the Norwegian systemic risk buffer requirements are irrelevant from the perspective of individual Finnish credit institutions and that therefore the reciprocation of the systemic risk buffer requirement is not warranted in Finland.

According to Nordea Bank Abp, there are overlaps between the risks underlying the Norwegian systemic risk buffer requirement and the buffer requirements applicable to O-SIIs. The FIN-FSA also finds that it cannot be excluded that there is partial overlap between some of the criteria for the determination of the Norwegian systemic risk buffer requirement and the O-SII buffer requirements (e.g. interconnectedness, concentration). As a result, observing the prudence principle, the FIN-FSA has decided to partially reciprocate the Norwegian systemic risk buffer requirement.

Nordea Bank Abp sees an overlap of risks between the Norwegian and the Finnish systemic risk buffer requirements. The FIN-FSA is also of the view that the Norwegian and Finnish systemic risk buffer requirements are partly targeted at the same risks. Due to the partial overlap of the risks covered by the Norwegian systemic risk buffer requirement and the Finnish systemic risk buffer requirement, according to the FIN-FSA's decision, credit institutions must only meet the higher of these requirements (chapter 10, section 9(3) of the Act on Credit Institutions).

According to Nordea Bank Abp, the stress test used as the basis for the determination of the level of the Norwegian systemic risk buffer requirement only applied to the largest Norwegian credit institutions and did not include Nordea Bank Abp or its subsidiaries. Hence, Nordea Bank Abp finds that the results of the stress tests cannot be applied to a firm whose risk weights and structure of operations differ from Norwegian credit institutions. The FIN-FSA believes the reason why the stress test did not apply to foreign firms is that branches operating in Norway do not have prudential requirements under valid regulation. However, the FIN-FSA acknowledges that the stress test used in determining the level of 4.5% of the Norwegian risk buffer requirement excluded foreign credit institutions' branches, which increases uncertainty about the proportionality of the requirement and therefore supports the reciprocation of the Norwegian systemic risk buffer requirement in part.

Other systemically important institutions (O-SII)

Pursuant to chapter 10, section 8 of the Act on Credit Institutions, the FIN-FSA has reviewed the additional capital requirements applicable to other systemically important institutions (O-SII) set by the FIN-FSA Board on 27 June 2022. In the review, no grounds have emerged to adjust these capital requirements, and therefore no new decision on the matter has been made.

Based on the O-SII scores as at end-2022, O-SII credit institutions comprise Nordea Bank Abp, OP Financial Group and Municipality Finance Plc, as in the previous years. Reflecting buffer recommendations based on different methodologies and the reasons stated above, the FIN-FSA finds it justified to keep the O-SII buffers of all three O-SIIs at their current levels: 2.5% for Nordea Bank Abp, 1,5% for OP Financial Group and 0.5% for Municipality Finance. The systemic importance of Finnish O-SIIs has not changed significantly during the year, and therefore the O-SII buffer requirements reviewed in

June 2022 can be regarded as proportionate to the systemic risks related to the systemic importance.

The FIN-FSA publishes the updated principles for identifying other systemically important credit institutions (O-SIIs) and setting additional capital requirements on its website.