Analysis

Systemic risk buffer protecting the banking sector under difficult conditions

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The systemic risk buffer became available in Finland from the beginning of 2018. The systemic risk buffer is an additional capital requirement that may be imposed on credit institutions on the basis of the financial system's structural risks. The buffer may be up to 5% of the total risk exposure. Its purpose is to strengthen the credit institution sector's capital adequacy in case of structural risks and vulnerabilities affecting the financial system. Sufficient capitalisation improves credit institutions' ability to operate and to intermediate finance under difficult conditions. According to a preliminary estimate, Finland's financial system has greater structural risks than other EU countries, which is the statutory requirement for imposing a systemic risk buffer.



As of the beginning of 2018, Finland began to apply a new macroprudential tool called a systemic risk buffer. The systemic risk buffer is an additional capital requirement imposed on credit institutions on the basis of the financial system's structural risks.

The purpose of the systemic risk buffer is to ensure that credit institutions' capital is in sufficient proportion to the structural risks and vulnerabilities present in the financial system. Sufficient capital enables credit institutions to operate even under difficult circumstances. A low capital ratio would intensify banking crises and other serious problems affecting financial stability.

A systemic risk buffer is justified if the structure of the financial system increases the risk of disruptions in the operations of the credit institution sector and hence the economy as a whole. Structural risk may exist if, for example, banks grant credit disproportionately to a single economic sector, such as construction or real estate. If the sector gets into difficulty, such a concentration of risks may burden the normal operation of banks and thereby the entire system.

The importance of the credit institution sector in intermediating financing is another reason why credit institutions' capital adequacy should be ensured by means of a systemic risk buffer. Serious problems in banks and other credit institutions could seriously disturb financial intermediation, as other forms of finance by alternative providers are relatively few. Alternative sources of finance would be even scarcer if the credit institution sector was very concentrated. This could mean that finding alternative sources of finance even for an individual credit institution could be difficult. A credit institution sector providing a significant amount of concentrated financing for the private sector should be properly capitalised in order to continue to operate without disturbance even if individual banks encounter problems.

How is the systemic risk buffer set up?

The conditions for setting a systemic risk buffer are laid out in the EU's Capital Requirements Directive.[1] It was decided in late 2017 that the provisions in the Directive concerning the buffer would be included in the Finnish Act on Credit Institutions.[2] The Directive does not specify a maximum size for the buffer, but in Finland it may not be more than 5% of the credit institutions' total risk exposure. The revised Act contains transitional provisions according to which credit institutions will have to reach a buffer requirement of 1% by the beginning of 2019 at the earliest, and any higher requirement no earlier than 1 July 2019.

The buffer may be set for all credit institutions or just for selected institutions. The buffer may not necessarily be the same for all credit institutions. If a credit institution has been set both a systemic risk buffer and a buffer requirement for global or other systemically important institutions (G-SII/O-SII buffer), only the higher requirement is applied. An exception to this is a

situation in which the countercyclical capital buffer only applies to the credit institutions' domestic exposures (or exposures in third countries). In such a case, the credit institution must fulfil both the systemic risk buffer requirement and any other applicable additional capital requirement.

Whether a systemic risk buffer will be set is decided in Finland by the Board of the Financial Supervisory Authority (FIN-FSA). Any such decisions are made annually by the end of June. The FIN-FSA must, together with the Bank of Finland and the Ministry of Finance, assess the need for setting a buffer. The FIN-FSA must also request a statement not only from the Bank of Finland and the Ministry of Finance, but also from the Ministry of Social Affairs and Health. The buffer requirement generally takes effect 12 months after a decision has been made to set it.

Under the Act on Credit Institutions, the systemic risk buffer may be set if a risk consisting long-term non-cyclical factors threatening the financial system or the total economy calls for a higher capital requirement. The prerequisite is that this risk may threaten the normal operation and stability of the financial system on a national level. The buffer may only be set if other macroprudential tools are insufficient or unsuitable for covering the credit institutions' capital needs. For example, a countercyclical capital buffer is more appropriate to address a risk caused by a significant increase in cyclical lending.

In Finland, the discretion of Finnish macroprudential authorities is limited by law. The Act on Credit Institutions specifies risk factors to be taken into account when deciding on the systemic risk buffer. These factors include credit institutions' risk concentrations and interconnectedness; size, concentration and significance of the credit institution sector in terms of financial intermediation; and the indebtedness of the credit institutions' largest customers.

Discretion in setting up the buffer is also limited by the Ministry of Finance Decree[3] supplementing the Act on Credit Institutions and defining the indicators to assess the risk factors. The Decree also lists conditions which, when fulfilled, permit the setting of the systemic risk buffer.

A systemic risk buffer of up to 3% may be set if the systemic risk for Finnish credit institutions is higher than in other EU or euro-area countries. The same may be done if it can be assessed on the basis of at least three indicators that the systemic risk in Finland is higher than the long-term average.

A systemic risk buffer of between 3% and 5% may be set if the systemic risk is found to be clearly higher in Finland than in other EU or euro-area countries, or clearly higher than the long-term Finnish average.

The FIN-FSA must inform the European Commission and specific other authorities in advance if it plans to set a systemic risk buffer. Setting the buffer at more than 3% also requires authorisation from the Commission. The European Central Bank must also be informed in advance of any intention to impose a systemic risk buffer, and the ECB's view must be taken into account when making the final decision. The European Central Bank may also, if necessary, set the systemic risk buffer at a higher level than decided by the FIN-FSA.

The structure of the Finnish financial system has several characteristics that point at significant structural systemic risks. The housing market in particular forms a major risk concentration for Finnish credit institutions, made worse by the high indebtedness of Finnish households. The Finnish credit institution sector is significant in terms of intermediating financing; large in size and also concentrated; and dependent on international market financing.

Notes

1. Directive 2013/36/EU of the European Parliament and of the Council 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. ↑
2. Act on Credit Institutions (Act 610/2014). ↑
3. Ministry of Finance Decree 65/2018. ↑

Keywords

macroprudential policy, structural risks, systemic risk buffer