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FINLAND

FINANCIAL SECTOR ASSESSMENT PROGRAM

January 2017

TECHNICAL NOTE—BANKING SUPERVISION

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November 2016

TECHNICAL NOTE

BANKING SUPERVISION

Prepared By
Monetary and Capital Markets Department, IMF

This Technical Note was prepared in the context of an IMF Financial Sector Assessment Program (FSAP) mission in Finland during June 2016 led by Mr. Marco Pinon-Farah. It contains the technical analysis and detailed information underpinning the FSAP assessment's findings and recommendations. Further information on the FSAP program can be found at http://www.imf.org/external/np/fsap/fssa.aspx.

CONTENTS

Glossary

AML	Anti-Money Laundering
BCBS	Basel Committee on Banking Supervision
BCP	Basel Core Principles for effective banking supervision
BRRD	Bank Recovery and Resolution Directive
CCP	Central counterparty
CEO	Chief Executive Officer
CFO	Chief Financial Officer
CFT	Combating the Financing of Terrorism
COREP	Common Reporting (in the EU)
CRD	Capital Requirements Directive
CRO	Chief Risk Officer
CRR	Capital Requirements Regulation
DA	European Commission delegated regulation (EU) 2015/61
DB	Danske Bank
DG	Director General
DGS	Deposit Guarantee Scheme
EA	Euro Area
EBA	European Banking Authority
ECB	European Central Bank
ESRB	European Systemic Risk Board
EU	European Union
EUR	Euro
FFSA	Finnish Financial Stability Authority (*Rahoitusvakausvirasto*)
FIN-FSA (or FSA)	Finnish Financial Supervisory Authority (*Finanssivalvonta*)
FINREP	Financial Reporting (in the EU)
FSAP	Financial Sector Assessment Program
FVH	Fair Value Hierarchy
G-SIB	Global Systemically Important Bank
GDP	Gross Domestic Product
HQLA	High Quality Liquid Assets
HR	Human Resources
ICAAP	Internal Capital Adequacy Assessment Process
ILAAP	Internal Liquidity Adequacy Assessment Process
IMF	International Monetary Fund
INM	Internal Models Division
IRB	Internal Ratings-Based approach
IRRBB	Interest Rate Risk in the Banking Book
IT	Information Technology
ITS	Implementing Technical Standard
JST	Joint Supervisory Team

JSTC	JST coordinator
LCH	London Clearing House
LCR	Liquidity Coverage Ratio
LE	Large Exposure
LSI	Less Significant Institution
LTV	Loan-To-Value
MCM	Monetary and Capital Markets department
MEL	Minimum Engagement Level
MF	Municipality Finance ("Kuntarahoitus Oyj" in Finnish)
NBAB	Nordea Bank AB
NBF	Nordea Bank Finland
NCA	National Competent Authority
NIM	Net Interest Margin
NPL	Non-Performing Loan
NSFR	Net Stable Funding Ratio
OMM	Ongoing Model Monitoring
OTC	Over The Counter
RAS	Risk Assessment System
RCAP	Regulatory Consistency Assessment Program
RTS	Regulatory Technical Standard
RWA	Risk-Weighted Asset
SB	Supervisory Board (of the ECB)
SEP	Supervisory Examination Program
SI	Significant Institution
SREP	Supervisory Review and Evaluation Process
SSM	Single Supervisory Mechanism
SSMR	SSM Regulation
STE	Short Term Exercises data
TRIM	Targeted Review of Internal Models
U.K.	United Kingdom

EXECUTIVE SUMMARY

The introduction of the Single Supervisory Mechanism (SSM) in November 2014 significantly changed the FIN-FSA's responsibility for prudential supervision of the banking sector. The supervisory function within the European Central Bank (ECB) took over responsibility for prudential supervision of the largest banks in Finland, now holding more than 90 percent of the banking sector's assets. Three banks were designated as significant institutions (SIs) since the beginning and one more joined the group of Finnish SIs in 2016; the Finnish FSA (FIN-FSA) retained responsibility for supervising the nine remaining Finnish banks deemed to be less significant (LSIs).

Under the staffing model adopted by the SSM, the transfer of responsibility of prudential supervision of SIs to the ECB does not result in a reduction in the demands on FSA resources. While the ECB leads the supervision teams, most of the supervisors are expected to come from the national competent authorities (NCAs). Moreover, the ECB has adopted a more intense and intrusive approach to banking supervision than that typically followed by banking supervisors in the Nordic area. These higher standards, while initially focused on SIs, are also being gradually adopted by the ECB for application over time by NCAs in their supervision of LSIs. The result is that the creation of the SSM has increased rather than reduced the resource burden on the NCAs**.** This has stretched the supervisory resources of the FIN-FSA, which need to be augmented.

Another significant change will be the planned conversion of the largest bank in Finland, Nordea Bank Finland (NBF), to a branch of Sweden's Nordea Bank AB at the beginning of 2017. After this conversion ('branchification'), Nordea's branch, along with a standalone mortgage credit subsidiary, is expected to be the second largest bank in Finland.

Over the near-term, consistent with CRD, Finland and the ECB should seek to enter into an appropriate supervisory memorandum of understanding with Sweden covering large significant branches. The final version of the memorandum of understanding currently under negotiation (involving also the other supervisors in the region) should provide them with greater access to information and enhanced powers regarding supervisory engagement with the branches and parent banks. This effort should be organized around the core supervisory college for each banking group. Beyond multilateral agreements, for branches that are systemically important in a host country, consideration should be given in any future revisions of CRD IV to provide for enhanced supervisory powers for the host country supervisors, in close coordination with the home country supervisor. The objective of such revisions would be to facilitate the host country's understanding of the risks posed by the branch and to enable it to take actions to promote the resilience and resolvability of the branch.

The enforcement and sanctioning framework has been reinforced, though its functionality is yet to be tested in light of the complexity of the SSM arrangements. The SSM framework for enforcement and sanctioning is based on a combination of powers assigned either to the ECB or the NCAs, with the latter not being fully harmonized. Where the ECB lacks the powers to directly impose an enforcement measure or a sanction on a bank, it can request or instruct the NCAs to act, based on the powers available to them. This complex arrangement has not been put to the test so far in Finland.

The SSM Supervisory Review and Evaluation Process (SREP) is well structured, though the powers granted by the Finnish legislation to the FIN-FSA are not aligned with those required by the CRD. The SREP gives adequate emphasis to the analysis of banks' risks and the decisions on the adequate levels of capital and liquidity. However, the FIN-FSA is more limited in imposing supervisory measures than envisaged by the CRD. This impacts, for example, the FIN-FSA's ability to impose supervisory measures for deficiencies in internal governance or to require an adjustment of provisions for prudential purposes.

The upcoming SSM 'TRIM' project can help to reintroduce adequate conservatism in banks' IRB models, but needs to be accompanied by a sustainable framework for ongoing monitoring of models. The risk weights applied to mortgage exposures by Finnish banks using IRB models are, on average, the lowest in Europe. The FIN-FSA Board has proposed introducing a floor on risk weights of mortgage exposures in banks' IRB models. Nevertheless, there is an urgent need for the SSM to proceed with a thorough Euro area-wide review of banks' internal models.

The TRIM' project (Targeted Review of Internal Models), whose planning is ongoing and whose execution is expected in the next two years represents an important opportunity to address the current lack of comparability between models across the SSM and to address those situations where banks may have reduced the conservatism of their models to 'optimize' their RWAs. However, the authorities need to devise specific solutions (of organizational and/or procedural nature) to ensure that the results achieved can be maintained in the post-project phase, through the ordinary, ongoing monitoring of internal models.

The regulatory and supervisory framework for liquidity and funding risk has improved since the last FSAP, but certain vulnerabilities persist and require greater attention. Finnish banks continue to rely extensively on wholesale funding, as noted in the 2010 FSAP. While supervisory action has managed to mitigate the problem (e.g., by pressing banks to rebalance their wholesale funding in terms of maturities), many banks remain heavily exposed to the risk of a dry-up of unsecured wholesale funding. Also, banks hold covered bonds issued by other banks as part of their liquidity buffer. The EU implementation of the Liquidity Coverage Ratio, which is more generous than the Basel III framework as regards the eligibility of covered bond in the buffer, favors a high level of covered bond cross-holdings among banks, especially when looking at the wider Nordic area. This could become a particular source of contagion should a drastic correction in house prices materialize in the region and undermine market confidence in the otherwise solid covered bond sector. While the concentration risk and high reliance on covered bonds in banks' liquidity buffers is being addressed as a supervisory concern within the bank individual SREP decisions, the systemic risk stemming from bond crossholdings has not been adequately addressed. Given its cross-border nature, it lends itself to a EU-wide analysis and, if needed, action by the relevant supervisors (e.g., through collaboration in the supervisory colleges or regional macroprudential fora).

Table 1. Recommendations		
Main Recommendations		
1.	Ensure that the Finnish legislation grants the FIN-FSA all the powers it needs according to the CRD to impose decisions on capital and liquidity requirements and supervisory measures on LSIs. (MoF)	NT
2.	Increase the number of supervisory staff to accommodate the SSM demands of FSA staff on JSTs and inspection teams, and in response to the more intense supervision expected for LSIs. (FSA)	MT
3.	Strengthen the legal protection of the FSA officials and staff. (MoF, BoF)	NT
4.	Seek a supervisory memorandum of understanding with the Swedish authorities covering large significant foreign branches, providing for enhanced access to information and supervisory engagement with the branches and parent banks. (ECB, FSA)	NT
5.	Raise with the European Commission the question of how the CRD might be amended to retain the original objective of encouraging the free flow of financial services within the EU while, at the same time, providing host supervisors with additional authority over systemically-important institutions, in close collaboration with the home supervisor. (MoF, ECB)	MT
6.	Proceed with the announced comprehensive review of banks' internal models and devise, for the future, a sustainable form of ongoing model monitoring to prevent banks from reducing again the degree of conservatism in their models. (ECB, FSA)	MT
7.	Analyze, within the SSM and in collaboration with the other supervisors in the EU, the risks possibly stemming from the crossholding of bonds, in particular covered bonds and consider imposing concentration limits. (ECB, FSA)	MT
8.	Implement a regular data collection of individual loan files (e.g., a loan registry system) to better support the analysis of credit risk. (FSA)	MT
Other Recommendations		
9.	Reinforce FIN-FSA independence, by ensuring future Board members have diverse background and experience and are not concurrently serving in politically appointed positions. (MoF)	MT
10.	Continue to closely monitor banks' loan portfolios to verify the evolution of renegotiated loans. (ECB, FSA)	NT
11.	Update the on-site methodology to ensure that the samples of loan files analyzed during inspections are selected according to statistically robust criteria. (ECB)	MT

Table 1. Recommendations (concluded)		
12.	Establish a regular program to directly verify the correct classification and valuation of fair-valued positions and any consequent need for additional valuation adjustments in banks with consistent amounts of Level 2 and 3 assets. (ECB, FSA)	MT
13.	Closely monitor the impact on the bank's loss absorbency of the 'Danish compromise' waiver (allowing banks in financial conglomerates not to deduct insurance participations). (ECB)	NT
14.	Analyze the impact of the proposed law restraining municipalities tax-raising powers on Municipality Finance and the other banks. (ECB, FSA)	NT
15.	Ensure that the need for consistency of the supervisory methods and techniques does not distract energy, time and resources from more risk-focused tasks (ECB)	NT
16.	Improve the communication with the banks, including with respect to the outcome of the SREP. (ECB, FSA)	MT
17.	Improve the external communication strategy to further highlight the specificities of the SSM, especially as regards the difference between SIs and LSIs. (ECB, FSA)	MT
NT = Near Term (within 6 months / 1 year); MT = Medium Term (within 2-3 years)		

INTRODUCTION[1]

A. Scope and Approach

1. **The purpose of this note is to present the mission's assessment of banking supervision based on the discussions that took place during the 2016 FSAP mission in Finland.** These discussions on banking supervision practices - part of the 2016 FSAP for Finland - took place in Helsinki during April 5–11, 2016 and June 20–29, 2016 and included a visit to the ECB in Frankfurt on April 4, June 14–17 and June 30. This note uses the 2012 edition of the "Basel Core Principles for Effective Banking Supervision" (BCP) as the reference framework, but it does not contain a formal BCP assessment. Instead, the note updates the findings of the 2010 FSAP for Finland focusing on key aspects of organization and resources of the supervisory authorities (referring to BCP 1 and 2) in relation to their approach and techniques (BCP 8 and 9), the enforcement and sanctioning framework (BCP 11), the assessment of risks and capital adequacy (BCP 16 and also 17, 18, 22, 23), and the analysis of the adequacy of liquidity and funding (BCP 24).

2. **The mission maintained close coordination and consistency with other FSAPs in the euro area working on banking supervision.** In particular, the mission took into account the findings and recommendations with respect to the functioning of the Single Supervisory Mechanism (SSM) formulated by the 2016 Germany FSAP and Ireland FSAP missions.[2]

3. **The note includes an analysis of bank supervisors' practices in relation to selected BCPs in the context of a wider discussion of key issues in regulation and supervision.** In respect to the BCPs analyzed in the note, the authorities provided a full self-assessment, responded to a complementary questionnaire, and provided examples of actual supervisory practices and assessments. The discussion with the authorities included also an analysis of the implications, for the Finnish financial system and for banking supervision, of the announced transformation of the Finnish subsidiary of Nordea (accounting for more than 30 percent of the domestic loan and deposit markets) into a branch.

4. **The authors wish to thank the authorities and private sector participants for their excellent cooperation.** The authors benefitted greatly from the inputs received and exchanges of views had in meetings with supervisors, banks and industry and professional organizations.

B. Institutional Setting

5. **With the introduction of the Single Supervisory Mechanism (SSM) in November 2014, FIN-FSA's responsibility for prudential supervision of the banking sector changed significantly.** The SSM represents the first pillar of the European banking union; the other two are a

[1] This technical note was prepared by Pierpaolo Grippa (MCM) and Jonathan Fiechter (external IMF expert).

[2] The Germany FSAP mission, in particular, conducted a full BCP assessment (http://www.imf.org/external/pubs/cat/longres.aspx?sk=44020.0) The portion of that assessment referring to general SSM matters has been used as a fundamental input for the assessment of banking supervision of Finnish banks.

common framework for recovery and resolution (in the form of the Single Resolution Mechanism and Single Resolution Fund) and for deposit protection (at the moment limited to EU-wide harmonization of national schemes). The SSM comprises the ECB and the national competent authorities (NCAs) of the participating countries (currently only the members of the euro area). The ECB directly supervises 129 significant institutions (SIs) of the participating countries, representing almost 82 percent of total banking assets in the euro area (EA). The remaining banks (Less Significant Institutions or LSIs) continue to be supervised by their national supervisors, under the oversight of the ECB. NCAs also continue to be responsible for the supervision and regulation of consumer protection, payments systems, and AML/CFT in both SIs and LSIs.

6. The objective of the SSM is to establish a common approach to supervision and to foster the consistent application of regulations and supervisory policies across SSM countries, particularly by centralizing the prudential supervision of the institutions of significant importance. The governance of the SSM, as part of the European Central Bank (ECB), includes a Supervisory Board that comprises all heads of banking supervision in EA NCAs, and the Governing Council of the ECB, comprising all EA central bank governors. The Supervisory Board and Governing Council, which meets on average twice a month, review virtually every policy and supervisory decision related to prudential supervision of banks in the euro area. This process has added a significant administrative burden onto the staff of NCAs and central banks who need to prepare briefing papers for their principals attending the meetings.

7. The Financial Services Authority (Finanssivalvonta or FIN-FSA) is the supervisory authority for Finland's financial sectors and the Director General participates in the Supervisory Board of the SSM. The entities supervised by the FIN-FSA include banks, insurance and pension companies as well as other companies operating in the insurance sector, investment firms, fund management companies and the Helsinki Stock Exchange. Currently four Finnish banks are considered significant and are subject to direct prudential supervision by the ECB, in collaboration with the FIN-FSA and to the extent they have cross-border operations, other relevant NCAs. An additional 12 Finnish banks are designated as LSIs and are directly supervised by FIN-FSA under the oversight of the ECB.

8. While it is formally under the administration of the Bank of Finland, the FIN-FSA's decision-making in supervisory matters is independent. The FIN-FSA's Board oversees its supervisory activities. The Board is composed of five members appointed by Parliamentary Supervisory Council for a three-year term. The Ministry of Finance, the Ministry of Social Affairs and Health, and the Bank of Finland each nominate one board member and the Parliamentary Supervisory Council chooses two independent members. The board members appointed at the recommendation of the Bank of Finland, the Ministry of Finance, and Ministry of Social Affairs, are all officials currently serving in these agencies. The Deputy Governor of the Bank of Finland chairs the Board. Once a year, the Board provides the Parliamentary Supervisory Council with a report on the operational objectives of FIN-FSA and their achievement.

9. The Parliamentary Supervisory Council also appoints, and may dismiss, the Director General (DG), on the recommendation of the Board. The DG's term of office is five years. The

Parliamentary Supervisory Council also designates the deputy to the DG, again on the recommendation from the board. In case of removal of the DG, the board needs to motivate its proposal.

10. The board decides the overall strategy of FIN-FSA, sets operational objectives, and directs and supervises achievement of the objectives and compliance with the strategy. The Board consults representatives of financial market participants annually to gather their views on FIN-FSA's budget, changes in FIN-FSA's supervisory work and the impact on supervision fees. The Board develops the proposed budget of FIN-FSA and submits it to the Board of the Bank of Finland for confirmation; the Board generally approves it with no modification.

11. The Board also approves the regulations proposed by the FIN-FSA and decides on penalty payments and other administrative sanctions other than the ones for which the ECB has competence over. The Director General, who is not represented on the Board, is responsible for managing the activities of the FSA. The DG is obligated to keep the board informed, in advance, of decisions where the matter is far reaching, expresses an opinion on financial market developments, or, for instance, is a specific supervisory action related to a supervised entity that restricts its activities or effects its capital, such as payment of dividends or raises capital requirements.

12. From the perspective of the best international practices, related to operational independence of supervisors, the composition of the Board, with officials from Ministry of Finance and Ministry of Social Affairs serving as board members, creates the appearance of a lack of independence. While the mission is unaware of any inappropriate interference by the Board in the decision made by the FSA, appointing Board members in the future from outside of government would reduce the risks of such potential conflicts.

C. Market Structure

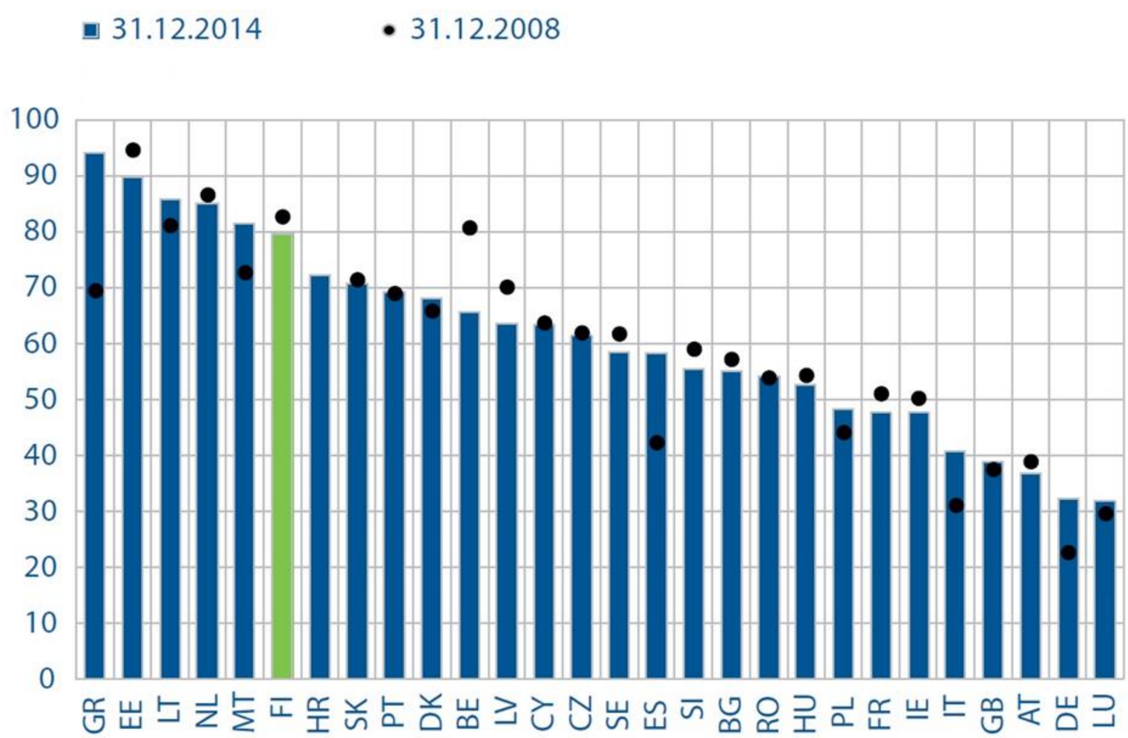
13. Finland's banking system is relatively large and concentrated, with total assets equivalent to 230 percent of GDP; two-thirds of banking assets are in foreign-owned banks. There are approximately 250 credit institutions in Finland, though most of these are local co-operative or savings banks belonging to amalgamations of deposit banks (OP Group, Savings Banks Group and POP Banks Group). There are eight other banking groups; two among them are owned by foreign banks: Nordea Bank Finland (NBF), whose parent is Nordea AB (Swedish), and Danske Bank (DB), owned by Danske Bank AS (Danish).[3] Together with OP Group, the largest domestic banking group, these three banks account for more than 85 percent of the market in terms of assets and deposits. The Finnish banking system is among the most concentrated in Europe (see Figure 1). OP, NBF, and DB are three of the four Significant Institutions, subject to direct supervision by the ECB within the SSM; the fourth one, designated at the beginning of 2016, is Municipality Finance (MF), a non-deposit taking credit institution jointly owned by the municipalities and with assets representing around 6.6 percent of the banking system.[4]

[3] The other banking groups are Aktia Bank, S-Bank, Bank of Åland plc, Oma Savings bank, Hypo Group, and Evli.

[4] A new legislative proposal, put forward by the government, would put a cap on municipalities' tax-raising powers for four years (2019–2022). Based on CRR, the possibility to raise taxes is a fundamental requirement for local

(continued)

Figure 1. Five Largest Banks' Share of Total Baking Assets



Source: MoF

14. There are significant financial linkages between some banks and non-bank financial firms. Many non-bank financial firms are part of financial conglomerates. For example, OP Group controls both the largest domestically-owned bank and the largest Finnish non-life insurance company. In other cases, insurance companies have significant exposures to banks through their equity holdings. One example is Sampo Group, which controls two of the largest insurance companies in Finland and owns 20 percent of the shares of Nordea, the Swedish bank whose Finnish subsidiary is the largest bank in Finland.

15. While all banks have universal banking licenses, most concentrate on retail banking.[5] Housing loans represent by far the most significant form of lending and account for approximately

administrations to be applied a preferential risk weight (as for sovereign exposures, i.e., 0 percent under the standardized approach). Should the law be approved, the question emerges of whether the bank's exposures to municipalities (the majority) should switch from 0 percent to a non-zero risk weight (likely 20 percent), with a clear impact on MF's capital ratios. This change in the municipalities' tax-raising power could also affect the guarantee of the Municipal Guarantee Board on MF securities, with an impact on the holdings of such securities by other banks (currently risk weighted at 0 percent) and, via the change in their demand for the securities, on the funding costs for MF.

[5] The relevant exception being Nordea, which serves as the hub for the capital market activities of its group and whose balance sheet is composed 50 percent of derivatives.

half of the banks' loan portfolio. Net interest margin (NIM) is the most important source of income for Finnish banks. The drop in NIM caused by the low interest rate environment has been compensated, at least partly, by commission fees and trading income; revenues from insurance activities are also increasingly gaining importance in banks' profits. Profitability has benefitted as well from cost cutting programs implemented by most banks, which has helped them to keep their cost/income ratio under control.

16. The banking sector's cross-border exposures are significant and complex. Cross-border exposures include assets of around 120 percent and liabilities of more than 150 percent of GDP and majority of them are to Nordic region, with considerable exposures to U.K. and other European countries. Most of cross-border claims are between banks and financial institutions. Cross-border derivatives amount to 23 percent of banks' total liabilities; excluding derivatives, two thirds of exposures are in loans and deposits, while one third of foreign exposures are in debt securities. In terms of currencies, the largest exposure is in euros followed by U.S. dollars and other Nordic currencies.

17. Currently credit risk appears moderate, but coverage ratios are low in the international comparison. The average NPL ratio is 1.57 percent of total loans (1.62 percent for SIs, 1.15 percent for LSIs): important factors explaining this comparably low level of NPLs among EU peers are the banks' flexibility to negotiate the terms of loans for clients facing difficulties, and the deeply entrenched payment culture. Coverage ratios are around 30 percent; this level is at least partially justified by the specificity of the Finnish context: for example, in the mortgage segment (very material for Finnish banks) foreclosure is rarely activated, as banks prefer to pursue voluntary sales of homes by their defaulting customers.

18. Wholesale funding, particularly from external sources, plays a major role in financing credit in Finland. Banks rely on wholesale funding, as reflected in the 124 percent loan-to-deposit ratio. Wholesale funding accounts for more than half of banks' funding and the main instruments are deposits from credit institutions (20 percent in total funding), covered bonds (10 percent), senior unsecured bonds (10 percent), repo transactions (8 percent), and commercial paper/time deposits (6 percent).[6] A majority of this wholesale funding is provided by foreign financial institutions, including parent banks.

19. Capital adequacy of the banking sector, on a risk-adjusted basis, appears adequate. The overall capital adequacy ratio of the banking sector (excluding MF) increased to 23.1 percent at the end of 2015 from 17.3 percent of end 2014. The common equity tier 1 (CET1) ratio also improved, and it was 21.0 percent at the end of 2015 (15.8 percent at the end of 2014). The improvement of capital adequacy is due to both organic growth (retained earnings) and injections of new capital, which increase the numerator of the ratio (capital), and more extensive use of internal models, which reduces the denominator (risk weighted assets or RWAs). The credit risk density (RWAs for credit risk over total assets) has decreased significantly since 2007, when the first IRB models were approved.

[6] Given the peculiarity of Nordea group's derivatives being booked in Nordea Finland's balance sheet, Finnish banking sector funding is calculated by excluding derivatives and shareholder's equities from the balance sheet.

While the overall credit risk density of Finnish banks is close to the median in Europe, that for mortgage exposures is the lowest.

20. It is anticipated that a significant change in market structure may occur at the beginning of next year as a consequence of the largest bank in Finland, Nordea Bank Finland (NBF), converting to a branch of Sweden's Nordea Bank AB. Similar conversions are planned for Nordea subsidiaries in Denmark and Norway. Under what is described as "branchification," the foreign subsidiaries of Nordea will be merged into the Swedish bank, Nordea Bank AB (NBAB), and the assets of the subsidiaries will be shifted into branches of NBAB. This conversion is expected to take place in early 2017 assuming that satisfactory approvals are received from the relevant authorities in Denmark, Finland, and Norway.[7]

21. Nordea Bank Finland (NBF) is the largest bank in Finland with assets at year-end 2015 of €301.6 billion, almost threefold the next largest Finnish bank, Op Group. Even after branchification, Nordea's branch, along with a standalone mortgage credit subsidiary, is expected to have a market share of almost one-third of total deposits in Finland. This will make it the second largest bank in Finland.

MAIN FINDINGS

A. Organization

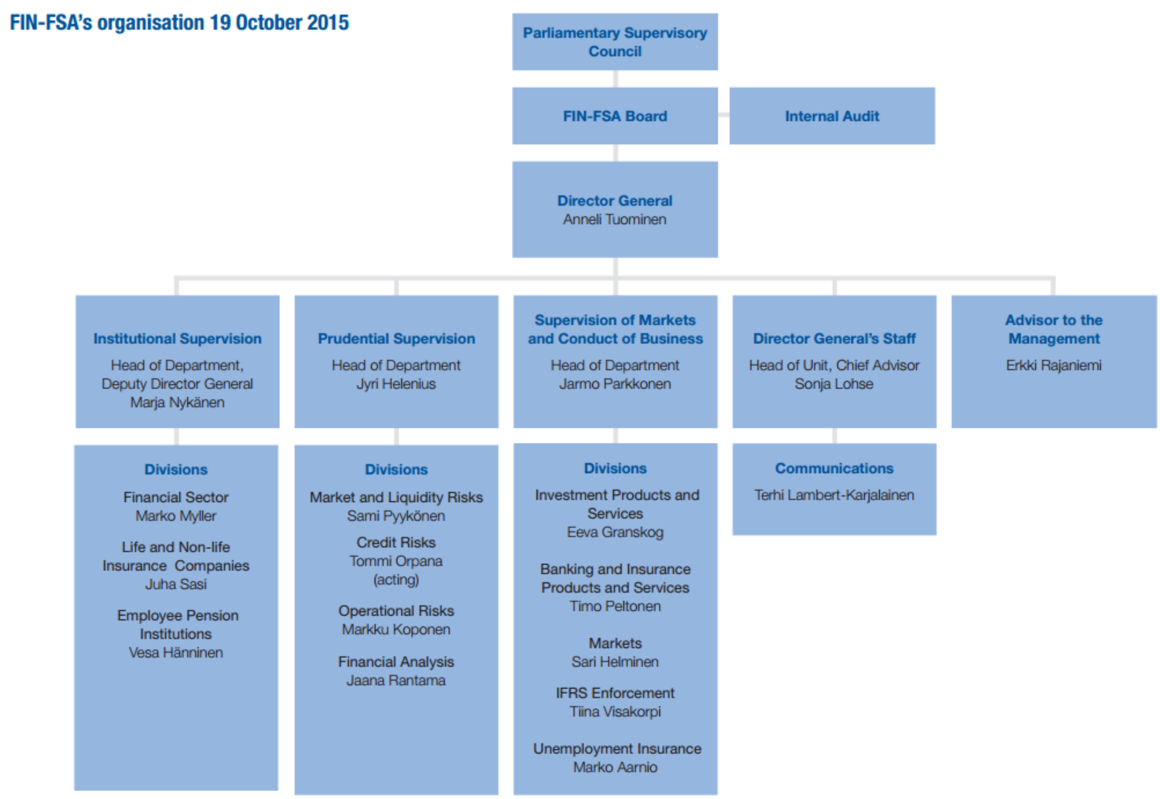
22. FIN-FSA's internal organization reflects its role as part of an integrated supervisor. It includes: a department in charge of institutional supervision, with 'line' supervisors for banks and non-banks; a department for prudential supervision, with risk specialists and other experts; a department for the supervision of markets and business conduct; a support unit for the DG (see Table 1). The Board appoints the heads of department, while the DG is authorized to appoint staff below heads of departments. The DG is assisted by an advisory management group, consisting of the heads of department, as well as other employees appointed by the DG to the management group.

23. In contrast with some euro area bank supervisors, the FIN-FSA has not adapted its organization to conform to the structure of the ECB – with dedicated teams devoted to on-site inspections. There is no on-site unit with dedicated staff; inspection missions are staffed with supervisors and financial experts from those departments and divisions that best fit the particular topic of each inspection. While this allows the limited number of staff in the FIN-FSA to cover more areas (i.e., to multitask), it also means that there are fewer resources available to staff on-site missions. Staff that are assigned to JSTs may also be assigned to on-site missions. FIN-FSA staff have not been able to participate in inspection teams formed by the ECB to look at banks outside of Finland (which would be a valuable experience), nor, due to resource constraints, have they been

[7] Nordea press release reporting results of annual general meeting (March 17, 2016)

able to meet all of the requests made by JST coordinators to staff inspection teams assigned to inspect Finnish SIs.

Table 2. FIN-FSA Organization.



Source: FIN-FSA

24. With the introduction of the SSM, FIN-FSA participates in the Supervisory Board (SB) of the ECB. The FIN-FSA Board appointed the DG as the FIN-FSA's representative in the SB. This is in keeping with the intent of the SB, which seeks to take advantage of the supervisory expertise of national supervisors.

25. An Interagency Group has raised the question of whether the FIN-FSA Board should be more involved in reviewing matters and preparing position on various items that come before the ECB's Supervisory Board. Examples of such items proposed by the Interagency Group included the budget and funding of the supervisory function at the ECB, any significant supervisory decisions and actions involving individual SIs, and proposed SSM regulations and guidelines. This does not appear consistent with the SSM regulation, which expects members of the SB to act exclusively in the interests of the Union as a whole and requires that the representative be independent and not subject to instructions or influence from government, any public or private body, or industry interference. Also, given the volume of items coming before the Supervisory Board, and the fact that, often, items are raised shortly before the meetings, it would seem impractical for the FIN-FSA Board to play such a role. Given the long delays in decisions being made by the SSM, it is very important that the Supervisory Board operate in an independent and efficient manner and that Members have the ability to decide on positions during the Supervisory Board meetings in the interests of the Union, without being required first to consult with their home authority.

B. Supervisory Resources

Demand on supervisory resources

26. Since the global financial crisis, most supervisory agencies have increased the resources devoted to bank supervision. The 2012 revision of the Basel Core Principles for Effective Banking Supervision places increased emphasis on the supervisory review process; the Basel III capital and liquidity standards introduce new supervisory requirements as well as enhanced prudential standards; in Europe, the European Banking Authority (EBA) guidelines and technical standards include many minimum requirements for supervisory review and entail a higher degree of supervisory intrusiveness; and greater supervisory intensity is now expected for systemically important banks. There is an expectation of a much greater level of engagement between senior supervisors and the senior management and board members of commercial banks.

27. In the light of the approach to banking supervision in the aftermath of the crisis, and given the staffing model adopted by the SSM, the transfer of responsibility of prudential supervision of the four major Finnish banks to the ECB has not resulted in a reduction in the demands on FIN-FSA resources. When the SSM was set up in the ECB, a number of supervisors were hired by the ECB to relocate to Frankfurt. Policies and guidelines were developed to concentrate authority and decision-making for SI supervision in the ECB. But it was also agreed that most EA bank supervisors would remain in their NCAs.

28. To supervise SIs, it was decided that Joint Supervisory Teams (JSTs) would be created, supplemented by separate on-site Inspection teams. The JSTs would be coordinated by ECB supervisors, but would be staffed primarily by teams from the relevant NCAs, under the supervision of NCA subcoordinators. Similarly, the on-site inspection teams would be comprised of a combination of staff from the NCAs and the ECB, depending on the nature of the expertise required for the area being reviewed by the on-site inspection.

29. The SSM, therefore, has placed heavy reliance on local bank supervisors to staff both the on-site inspections of SIs as well as to staff the JSTs that carry out off-site supervision of SIs under the direction of ECB staff. The expectation has been that the staff in the NCAs (like the FIN-FSA), which were formerly supervising the SIs, would continue as part of the JSTs so that the institutional knowledge of the individual banks and local markets is retained.

30. The amount of supervisory resources that are now required to carry out banking supervision has also increased. As in many other countries, following the global financial crisis, the ECB has adopted higher expectations related to the supervision of systemically important banks. Policies have been introduced that have made banking supervision more intense and intrusive, resulting in longer and more detailed examinations of risk areas in the banks and much more interaction with senior management and board members related to topics such as risk appetite, business strategies, and governance. These higher expectations, while initially focused on SIs, are also being gradually adopted by the ECB for application over time by FIN-FSA (like other NCAs) in its supervision of LSIs.

31. As a result, the creation of the SSM, and the designation of the large and complex banks as ECB-supervised SIs, has not reduced the resource burden on the FIN-FSA. Rather, when combined with the more intense and intrusive approach to supervision that has been adopted by the ECB, and the role assigned to FIN-FSA in the operations and decision-making of the SSM, the effect on FIN-FSA of the formation of the SSM may be an increased demand on its supervisory resources.

32. With respect to LSIs, under the SSM model, these institutions remain the direct responsibility of the FIN-FSA to supervise, under the oversight of the ECB. At the same time, the ECB is introducing supervisory guidance for LSIs, in keeping with EBA policies and with input from the NCAs. This has meant that many NCAs have increased the amount of time spent supervising LSIs since creation of the SSM.

33. For both SIs and LSIs, the time absorbed by coordination activities has also increased. For SIs, beyond the day-to-day coordination between its ECB and NCA components, JSTs are also involved in a number of other horizontal tasks that are partly needed for the start-up of the SSM (like the creation of common methodologies), but also a reflection of the wide diversity of the banks supervised by the SMM and the consequent need to conduct frequent horizontal analyses to investigate emerging phenomena and ensure harmonization of supervisory practices. For LSIs, the oversight role of the ECB requires that the FIN-FSA ensures regular notifications and reporting, participate in periodical thematic reviews, and contribute to workshops, working groups, drafting teams, etc.

34. Finally, under the current governance arrangements of the SSM, both the head of each NCA as well as the central bank governor are expected to actively engage in the discussions and recommendations/decisions of the Supervisory Board and Governing Council. Because of the limited possibility to delegate its responsibilities, the Governing Council of the ECB is directly invested with making a relevant number of decisions: e.g., in 2015 more than 1,500 decisions were taken by the Governing Council (mostly via written procedure), half of which concerned the approval of appointments of Board members and senior managers. Other decisions, while less numerous, still call for heightened attention (e.g., SREP capital decisions, qualifying holdings, etc.). This imposes an additional burden on the senior financial sector staff of all euro area countries to review and brief their principals on agenda items, independent of the size of their financial sectors. Certain EA countries have set up a dedicated secretariat to handle the increased paper flow.

Availability of supervisory resources

35. In 2015 the FIN-FSA had staff totaling approximately 186 full-time equivalent (FTEs). Staffing levels have been roughly flat since the last FSAP in 2010 and are expected to remain the same over the next several years.[8] Within FIN-FSA, approximately 60 FTEs are devoted to banking supervision. In addition, the banking supervision function receives administrative support (e.g., HR, IT, statistics, analytics) reportedly equivalent to another 21 FTEs for a total of 81 FTEs.

36. The FIN-FSA benefits from a strong cadre of experienced banking supervision staff. On average, FIN-FSA reports that its managers have 11 years of relevant experience, and the staff have an average of 12 years of supervisory experience. A large majority worked previously in the private sector, typically banks, insurance companies and funds. As is common among many other supervisors, the turnover level among the junior staff (with less than 3 years of experience) is relatively high (22 percent in 2015).

37. In past years the FIN-FSA has pursued efficiency gains. While FIN-FSA, and the BOF, which approves the budget of FIN-FSA, are independent agencies, their budgets are still expected to reflect government policy. As a result of the Finnish government's expectation of increasing efficiency within the public sector, FIN-FSA has had a long-standing policy of budget tightening. The fact that most of FIN-FSA's budget is paid for by the regulated industry rather than the taxpayer does not seem to have factored into the budget decisions.

38. The result is that, notwithstanding the increased demands on banking supervisory resources in FIN-FSA in recent years, its budget has not been increased. This has constrained and will continue to constrain the ability of the FIN-FSA to adequately cover the whole range of activities required of a supervisory authority in a financial sector of the size and complexity of the Finnish one, with significant cross border operations and a wide-range of activities arising from the universal bank model. The tight budget has made it difficult for the FIN-FSA to meet the expectations of the ECB and to keep the pace with the increasing demands on supervisors stemming from the post-crisis regulatory reform. The mission, for example, found evidence of recent SSM inspections of banks uncovering issues that had been present for years but had not previously been targeted. Given the strong experience level of Finnish supervisors, the omission was likely due to resource constraints.

39. The resource contribution of the FIN-FSA to the work of the SSM is less than what has been requested by the ECB. The FSA has assigned approximately 33 FTEs to supervisory tasks (off-site and on-site) and 35 to other SSM-related tasks (horizontal activities, statistics, financial stability, IT, etc.). Out of those dedicated to supervisory tasks, 13 FTEs were assigned to the JSTs supervising the Finnish SIs. But because of resource limitations and the need to assign multiple tasks to individuals, these 13 FTEs were comprised of 33 different individuals with allocations of time ranging

[8] There has been some reallocation of staff from FIN-FSA to the support function in the BOF, which resulted in a lower headcount in the FIN-FSA, but not a reported reduction in FIN-FSA output.

between 10 and 90 percent, for an average of around 40 percent. Apart from the low number of FTEs assigned,[9] experience shows that using multiple staff part time, rather than having dedicated staff, increases the efficiency losses. Below a certain level of dedication,[10] the accumulation of competing tasks compromises the ability of staff to provide a meaningful and sustained contribution, even more so when staff assigned to a JST covers horizontal functions within the FIN-FSA (e.g., risk specialist). Finally, a conservative assignment of resources reduces the margins of flexibility with respect to all kinds of contingencies (staff leaves, sudden need to reallocate a resource to a new, urgent task, etc.).

40. The FSA Board has preliminarily indicated that it intends to reduce staff modestly over the next several years, in keeping with a government policy of maintaining tight budget controls and reducing public spending. The proposed restructuring of Nordea from a subsidiary to a branch will result both in a smaller Nordea asset base in Finland, and reduced fees to the FIN-FSA, given that most of the remaining assets will be in a branch rather than a bank. The mission understands that the intention of the Government is to offset this reduction by revising the legislation governing the fee schedule paid by banks and branches so that FIN-FSA budget will not need to be reduced. While this would be a positive outcome, the government would also agree to cap any future increase in bank fees to roughly current levels. Even though the law can always be changed, this measure could put even more pressure on FIN-FSA's budget in the future.[11]

41. The leadership of FIN-FSA needs to consider whether the decision to maintain tight restrictions on resources and modestly decrease staff may be putting Finland's financial stability at risk over the longer-term. The challenge facing Finland, and many other small countries, is that it is difficult to justify a large supervisory function, particularly when other government agencies are downsizing. On the other hand, the financial system in Finland is multiples of GDP. While the Nordic region has not had a financial crisis for over 15 years, often crises arise when least expected and after a period of calm. Banking crises cannot be prevented, but their severity can be reduced through keeping imbalances in check and having in place a strong cadre of experienced supervisors. It is recommended that the FSA in fact gradually increases the number of its supervisory staff to accommodate the demands of the ECB for FSA staff to supervise SIs and the more intense supervision expected for LSIs.

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[9] In two JSTs, for example, the FTEs assigned for the supervision of the other non-Finnish banks are more than double than those assigned to the Finnish ones, notwithstanding a similar size and a lower degree of complexity with respect to the Finnish banks.

[10] Based on discussion with the JST coordinators, who are experienced supervisors, who noted that staff allocations of time below 50 percent jeopardize the productivity of staff, irrespective of their quality, skills and expertise. These staffing issues are in part a function of the decision to have relatively small number of staff assigned to banking supervision.

[11] In addition, Article 30 of the SSM Regulation provides for the levying of an annual supervisory fee by the ECB on branches established in a participating Member State by a credit institution established in a non-participating Member State. The fees levied by the ECB should cover, and not exceed, expenditure incurred by the ECB in relation to the tasks conferred on it under Articles 4 to 6 of Regulation (EU) No 1024/2013 in line with Article 2(7) of ECB Regulation ECB/2014/41.

42. Legal protection of the FSA's officials and staff should be strengthened. The MoF explained that under Finnish law the State is ultimately liable for damages suffered by third parties; the State has recourse to officials and staff if the damages have been caused by their actions or omissions. FSA and FFSA staff advised, however, that third parties may also take legal action directly against the agencies and their officials and staff. Finnish financial sector legislation does not include clauses to provide officials and staff of the agencies legal protection for actions and omission in good faith in the exercise of their official duties. The Finnish equivalent of "good faith" will need to be determined and enshrined in legislation. Then operational arrangements will be required to make this protection effective.

C. Supervisory Approach

Significant Institutions

43. The supervisory process adopted by the ECB is robust and conducive to a more structured, intense and intrusive supervision. It is based on the EU-wide Supervisory Review and Examination Process (SREP) as prescribed by the CRD (art. 97 and following), follows the EBA Guidelines on SREP,[12] and is further detailed in the SSM supervisory manual. It is applied at the consolidated, sub-consolidated and single-entity levels (unless an entity has been waived from supervision on an individual basis in accordance with Articles 7, 8, 10 of the CRR).[13] The supervisory process relies extensively on quantitative and qualitative analysis, combining data (form FINREP, COREP, and other standard reports) and expert judgment. It takes into account the risks that banks or banking groups present to the safety and soundness of the banking system.

44. Each SI is supervised by a Joint Supervisory Team (JST) led by an ECB coordinator, comprising staff from the ECB and the NCAs involved. These teams undertake day-to-day supervision and conduct yearly SREPs on their banks, reporting to the ECB Supervisory Board, which is in charge of recommending the final decision on the adequacy of capital and liquidity, formally taken by the Governing Council of the ECB.

45. The SREP is built on four elements.[14]

a. business model and profitability assessment;

b. internal governance and risk management assessment;

c. risk-by-risk assessment of risks to capital; and

d. risk-by-risk assessment of risks to liquidity and funding.

[12] Guidelines on common procedures and methodologies for the supervisory review and evaluation process (SREP) (EBA/GL/2014/13).

[13] In Finland some of these waivers have been granted to certain amalgamations of cooperative banks.

[14] Elements c) and d) are comprised of different sub-elements, separately assessed: credit risk, market risk, operational risk, and interest rate risk in the banking book (IRRBB) for element c); and short-term liquidity and funding sustainability for element d).

46. Each SREP element is assessed according to a common logical sequence. The assessment follows three phases: (i) data gathering; (ii) automated anchoring score generated by the Risk Assessment System (RAS); (iii) supervisory judgment, where the automatic scores can be adjusted by the JST based on additional factors and considering banks' specificities and complexity.

47. For the analysis of risks to capital, three different perspectives are combined: the supervisory perspective, based on the results of the RAS; the bank's perspective, based on its internal assessments of capital adequacy (ICAAP); a forward-looking perspective, based on the results of the bank's own stress-test, compared with (and challenged by) the results of the supervisory stress tests.

48. In the assessment of a bank's ICAAP, the supervisors carefully examine the plausibility and robustness of the bank's measurement of its risks and of the capital needed to cover them. For this purpose, the SSM methodology provides 'supervisory proxies' covering certain specific risks: credit risk (through a simplified Credit VaR), single name concentration risk, sector concentration risk, market risk (through a simplified VaR and Stressed VaR), IRRBB, and operational risk.

49. The assessments of the four SREP elements are performed at least with an annual frequency and result in an overall SREP assessment, which underpins a wide range of possible supervisory actions. The overall SREP assessment represents the basis for the JST to decide the most appropriate supervisory measures: capital decision, liquidity decision, and other qualitative or quantitative measures. The JST is required to exercise judgment and to incorporate, if needed, other relevant elements in the final decision, including the previous year's SREP score or additional peer comparisons.

50. There is a direct link between the supervisory assessment, the necessary supervisory measures, and the supervisory examination program (SEP). The annual planning process starts with the identification of supervisory priorities. Based on the identified priorities and on the categorization of banks in terms of their systemic footprint (6 'clusters' that break down the bank population in terms of size and complexity) and SREP scores (on a 1–4 scale), a supervisory examination program (SEP) is decided for each bank. The SEP identifies, for each bank, the minimum engagement levels (MEL), core activities to be performed risk by risk. In addition to MEL activities, JSTs include in their program additional SEP activities to address the needs and specificities of the institutions' risk profile.

51. As part of the SEP, the JST prepares an annual schedule of key meetings for each SI. Regular meetings are held both with the group's management and with the management of significant subsidiaries following the minimum engagement approach and applying the proportionality principle. The SEP covers the tasks and activities related to both off-site and on-site supervision. The on-site inspections are typically carried out by an inspection team, which – while organizationally independent – works in close cooperation with the JST.

52. In 2015 eight on-site inspections were carried out on the Finnish SIs. Topics included: asset classification (nonperforming exposures, forbearance) and provisioning; governance and risk management; operational risk management and risk control systems; liquidity risk; and IT issues. The average duration of the visits varied, with a tendency to increase, converging towards the SSM standard (approximately five weeks). The missions were staffed, on average, with four to five persons.

53. The needed standardization of supervisory methods and techniques sometimes might end up undermining a more risk-focused attitude. To ensure comparability across banks and consistency and accountability across the SSM – but also as a way to foster a convergence in approaches and styles between supervisors with completely different backgrounds – the methodology rests on a high degree of standardization and formalism (e.g., in the checklists that inspectors are required to use). While a certain degree of standardization is essential to establish a common language in such a new, vast, and multicultural organization, the risk should be avoided of a drift towards an excess of compliance-based techniques and of a distraction of energy, time and resources from more risk-focused tasks.

54. The feedback received from the industry points to an overall improvement in the level of supervision, while also revealing margins of improvements in the communication between supervisors and banks. The supervised entities observe that – discounting the inevitable bumpiness of the first year of functioning of the SSM–the supervisory approach of the SSM is more intense and intrusive, that supervisors are more in search of hard evidence and detailed information and that they have higher expectation about the banks' initiatives to mitigate their risks. At the same time, they observe that communication from the supervisors is not always satisfactory: for example, a better explanation of the purpose and final use of data collections is sometimes lacking, while it would help them to better meet the supervisors' requests. Whenever feedback has been given (e.g., in the case of the benchmarking exercise), banks always found it very helpful.

55. The smaller banks and FSA staff observe that a better external communication strategy would be needed to highlight the specificities of the SSM, especially as regards the difference between SIs and LSIs. Market participants met by the mission underlined as that the larger public struggles to fully understand the division of responsibilities between different supervisory agencies and, in the case of the SSM, might tend to assume that NCAs continue to be responsible for SIs.

Less Significant Institutions

56. The FIN-FSA supervisory approach has largely benefited from the participation in the SSM. Like for the other Nordic countries, the supervisory approach in Finland was considerably less structured, intense, and intrusive than the one adopted by the SSM. The improvement in the conduct of supervision has been observed both by the FIN-FSA staff and the industry.

57. The SREP on Finnish LSIs is consistent with the EBA guidelines and gradually converging to the SSM approach. The SREP assessment is done on an annual basis for high priority LSIs, and every 2 or 3 years for the other LSIs.

58. Planning of supervisory activities on LSIs follows a different process at FIN-FSA. The FIN-FSA has an annual planning process for off-site supervision and a separate bi-annual planning process for on-site inspections. These plans reflect supervisory findings identified during supervisory activities.

59. The on-going supervision consists of meetings with banks, reviewing regulatory reports, bank internal reports and any other available relevant information. The frequency of meetings with the boards, senior management and internal audit functions depends on the importance and riskiness of the bank. The FIN-FSA holds a bi-annual press conference where it presents the situation of the financial sector.

60. The assessment of banks' situation is based on two rating systems: an automatic quarterly indicator-based rating and a comprehensive SREP rating system. The first is an indicator-based approach focused on five areas: capital adequacy, profitability, credit risk, liquidity, and IRRBB. Internal documentation provides guidance to supervisors on how to interpret the automatic ratings and how to act upon them. The rating has four possible outcomes and relating actions: normal supervision; enhanced supervision (including, for example, contacting the supervised entity and more frequent reporting); early corrective actions (like a requirement for the bank to hold own funds in excess of its capital requirements or to restrict distributions to shareholders); special corrective actions (including immediate corrective actions, special external auditing, and special administrator).

61. The overall SREP rating is determined as a combination of individual risk indicators and other information on the supervised entity. Currently, the rating is primarily based on the assessment of the supervisory expert, and supported by risk indicators. The FIN-FSA is currently in the process of updating the LSI SREP process to better align it with the EBA SREP Guidelines, in particular by developing supervisory 'proxies' to be used to challenge the banks' own ICAAP measurement of certain risks (initially IRRBB, spread risk and concentration risk).

62. The FIN-FSA approach to on-site inspections on LSIs is also converging towards the SSM approach. In 2015 there have been 23 on-site inspections on LSIs. While traditionally the FSA tended to minimize the time spent on the banks' premises, by collecting the needed data and then performing a desk-based analysis, it is now gradually converging towards the SSM approach for SIs, which leverages the time spent on-site to get a wider and deeper understanding of the inner functioning of the examined banks (e.g., by interacting more frequently with middle management and staff, by closely observing the performance of IT systems, etc.). FSA staff, while noticing the resource-intensive and time consuming nature of the new approach, also praised the heightened focus and insight that it allows.

Supplementary supervision on financial conglomerates

63. As a EU member, Finland has implemented the Financial Conglomerates Directive. The Directive regulates the designation of financial conglomerates – based on the relevance of banking, insurance, and investment activities in their business mix – and the identification of the competent authority (coordinator) responsible for leading the collaboration between the agencies in charge of supervising the different components of the conglomerate. The coordinator and the other authorities collectively exercise the supplementary supervision on the conglomerate, which consists of four areas: capital adequacy; risk concentration; intra-group transactions; internal control mechanisms and risk management processes.

64. Five conglomerates have been identified in Finland. Of these, two (OP and Aktia) are groups headed by banks; other two are headed by insurance companies and comprise Finnish banks (Sampo, major shareholder of Nordea AB; and Lahi Tapiola, which holds a participation in S-bank); finally, Taaleri is a conglomerate headed by an insurance company with no banks in the group.

65. ECB is the coordinator for OP, FIN-FSA for the remaining four. FIN-FSA coordinates its supplementary supervision activities with the other supervisors (e.g., the Scandinavian FSAs for Nordea AB and its subsidiaries). As part of this, it calculates the capital available in each conglomerate and the sectoral capital requirements to determine its overall solvency position; overviews the most relevant intra-group transactions and the degree of risk concentration; conducts a comprehensive risk assessment of the conglomerate, assigning scores to various profiles of its overall situation, depending on the relative importance of different forms of risk. The supplementary supervision of OP, whose operations are prevalently domestic, requires coordination between the ECB and the insurance supervision function of FIN-FSA. The SSM Supervisory Manual details the activities that the JST must perform, including how the SREP should incorporate a consideration of the potential impact of non-banking activities on the banking part of the group.

66. Deviating from the Basel framework, the CRR (art. 49) grants member states the option to allow banking groups that are part of a financial conglomerate the possibility not to deduct their participation in insurance companies (so called 'Danish' compromise). While technically this possibility is offered also by the Basel framework, it is subject to the condition that the alternative method (i.e., consolidation) does not result in a higher level of calculated capital; this condition is not present in the CRD, which effectively allows a banking group to get a higher level of capital recognized than it would be the case under Basel.[15]

67. While perfectly legitimate under the EU legislation, the effect of the exemption must be closely monitored and discounted for most practical purposes. The waiver implicitly allows a certain reliance on a source of capital that is not completely free to absorb losses arising in the banking side of the conglomerate. The art. 49 waiver has been granted to one of the two Finnish banking groups part of a conglomerate. Based on ECB calculations, the exemption determines a material increase in the banking group's capital ratios with respect to the case of deduction. The impact of the waiver on the group's capital should be taken into account (at least qualitatively) when assessing its capital adequacy.

[15] This deviation from the Basel framework has been highlighted in the Regulatory Consistency Assessment Report on the EU of the Basel Committee (December 2014).

D. Capital[16]

Credit risk

Significant institutions

68. **Supervision on credit risk is based on an overall robust process and is supported by adequate supervisory techniques, but lacks the availability of individual loan file data on a regular basis.** Aggregate data on lending are available from FINREP and COREP, but more granular data would be needed to better support the analysis of credit risk. At least for corporate lending, individual loan information will be available through the EA-wide AnaCredit project.[17]

69. **According to the EBA Guidelines on SREP, supervisors are required to assess the overall credit quality at portfolio level and the different quality grades within the exposure categories of "performing", "nonperforming", and "forborne."** The Guidelines do not refer expressly to the EBA definitions for the concepts of "non-performing" and "forborne" exposures,[18] even though they were originally intended to play a role as a benchmark for asset quality assessment. Supervisors are clearly recommended to use these definitions, in the same way as they were recommended to use them during the 2014 Asset Quality Review.

70. **Credit file reviews are performed during on-site inspections.** Upon JST request, on-site inspection teams may proceed to a credit quality review, with a sampling of credit files and financial analysis conducted to confirm the borrower's ability to repay. The individual procedures are defined in the pre-inspection phase based on the purpose of the mission and following a mutual agreement between the JST and Head of Mission. Data on loan losses (write-downs), extensions/rollovers, restructured loans, and nonperforming exposures can be collected by the examiners according to the mandate received. In 2015–2016 inspections were conducted, in particular, on two SIs and one LSI to verify the correct application of the rules on forbearance.

71. **While the inspections were material to uncover ongoing issues in the classification of assets (especially regarding the interpretation of forbearance), the non-statistical nature of the samples of loan files analyzed limits the possibility of follow-up.** With limited samples, not selected according to statistically robust criteria, no extrapolation is generally possible. Consequently, it is not possible to calculate a level towards which the supervisor would expect a given ratio (e.g., NPL ratio or ratio of forborne loans over total loans) to converge. The availability of such a benchmark would facilitate the follow-up activity, by allowing to monitor the situation through the analysis of a bank's periodical reports. The SSM is currently updating the SSM Manual to

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[16] Given the prevalence of credit risk in the capital requirements of Finnish banks, this section focuses mainly on this type of risk.

[17] AnaCredit is a project to set up a dataset containing detailed information on individual bank loans in the euro area, harmonized across all Member States. While NCAs are required to collect data only for exposures above EUR 25,000, the FIN-FSA is considering to remove the threshold and to collect data on all (corporate) loans.

[18] Implementing Technical Standard (ITS) on Supervisory Reporting (Forbearance and non-performing exposures).

provide a common credit risk on-site methodology to deal with credit file reviews. It will deal with sampling, classification of exposures, assessment of individual and collective provisioning, and evaluation of collateral.

72. The ECB can require SIs to adjust their provisioning. Art. 104 CRD, on supervisory powers, establishes that competent authorities should have the power to require institutions to apply a specific provisioning policy or treatment of assets in terms of own funds requirements and, where permitted, by accounting rules and regulations require it to increase provisions. The CRR and the CRD are unspecific as regards the power of supervisors concerning impairment in the financial statements, as the accounting powers of supervisors are not dealt with by these EU acts. The CRR requires assets and off-balance sheet items to be valued in accordance with the applicable accounting framework (art. 24) and the CRD states that supervisors are empowered to require banks to implement a specific provisioning policy but only for own-funds requirements purposes. The ECB bases its power to require additional provisioning (for prudential purposes) on Art. 16(2) of the SSMR.

73. Volumes of renegotiated loans to households were especially high during the first half of 2015 with respect to the corresponding monthly level in 2014. This was due to a dedicated campaign by a large mortgage lender to grant one-year grace periods from paying principal (provided the borrowers met certain risk criteria). The biggest competitors followed suit, either with their own equivalent campaigns, or granting grace periods on equivalent terms upon request. Following the termination of amortization holidays for some 14 percent of mortgages, interest-only mortgages now account for less than 4 percent of the total.

74. In the current situation credit risk in the Finnish banking system appears subdued and the supervisors adequately monitor it, though heightened vigilance is required on the evolution in the 'grey area' of renegotiated and forborne loans. After the dedicated campaigns ended in Q3/2015, volumes of renegotiated loans have remained at around four times the pre-campaign level. At the time of the assessment the reason for this had not been identified yet, while the general policies and practices for the recognition of forborne and non-performing exposures had been the object of on-site inspections (as mentioned above) and led to the formulation of specific recommendations.

Less Significant Institutions

75. For its supervision of credit risk in LSIs, the FIN-FSA relies on the EBA guidelines on SREP and on the indications of its standard on Credit Risk Management (4.4a). The FIN-FSA also adopts the EBA definitions of forborne and non-performing exposures.

76. FIN-FSA does not have the authority to impose additional own funds requirements to compensate for inadequate provisions. The FIN-FSA has authority regarding the correct implementation of IAS 39 requirements, and may give orders of a technical accounting nature, but cannot go beyond that.

77. The lack of granular data on household loans limits the possibility for the supervisor to closely monitor the evolution of certain phenomena (like the recent explosion of renegotiated loans). In Finland there is no central credit register. A credit bureau operates in the country, but it is only of 'negative' nature (i.e., it only reports delinquencies). FIN-FSA does not receive regular reporting on defaults of individual counterparties; such information is only requested in connection with credit risk inspections, e.g., when choosing a sample of loans to look at more closely. A new data collection, starting in Q3 2016, will require banks to report information on new housing loans and the relative collateral.[19] This information will allow FIN-FSA to monitor the loan-to-collateral (LTC) of new loans, as well as their LTV (based on the primary collateral). This information is on new lending, which means that the FIN-FSA will lack detailed information on the collateral backing up existing loans, which would be important to verify that banks' lending practices do not deteriorate by allowing weaker forms of collateral to prevail. The FSA also lacks information on the stock of renegotiated loans, though it can infer their flow from monetary statistics.

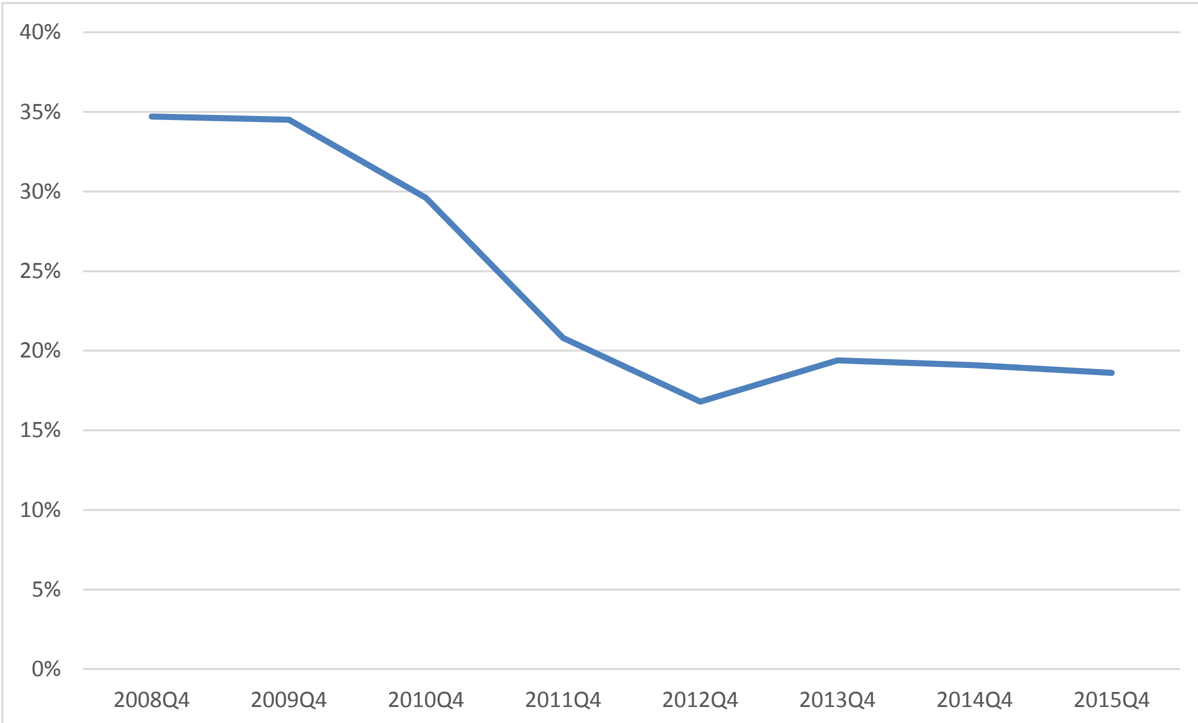
Internal models for credit risk

78. There are currently five banking groups with approved IRB models in Finland. The models cover different portfolios at each bank, including Corporate, Retail, and Institutions (i.e., banks). The first models were approved in 2007, the first year the Basel II framework was in force in Europe. Further model approvals were granted in the following years.

79. Credit risk densities of Finnish banks show an almost continuous decline since 2008. The credit risk density (ratio between credit risk-weighted assets and total assets) drops from 34.7 percent at the end of 2008 to 18.6 percent at the end of 2015 (see Figure 2). The decrease is more accentuated in connection with certain approvals granted to the major banking groups: as in other countries, banks have relied also on the extension of their internal models to lower their risk weights and hence, improve their reported capital ratios, sometimes via explicit 'efficiency programs.' Based on a cross-country comparison, Finnish banks' average risk densities are in line with the median for the EU, but those for mortgages are much lower.

[19] In Finland, a wide range of items other than the object of purchase are also recognized as eligible collateral (e.g., movable property, third parties' immovable property, financial securities).

Figure 2. Finnish IRB Banks' Credit Risk Density



Source: FIN-FSA

80. The ongoing monitoring of internal models, necessary to detect and contrast 'RWA optimization' practices by banks, has been limited in the years following the model approvals, likely because of supervisory resources constraints, though more attention has been devoted to the topic by the SSM since its beginning. This might have, inter alia, resulted in inadequate capitalization of IRB banks and compromised the 'level playing field' in the Finnish banking sector.

81. The FIN-FSA has recently decided to mitigate this problem through the imposition of a floor. Aware of the particularly low level reached by Finnish banks' IRB densities,[20] in June 2016 the FIN-FSA Board decided to introduce a floor of 10 percent for the average risk weight on housing loans of IRB banks. This minimum level would come into force on 1 July 2017 at the latest.[21]

[20] As remarked by Pentti Hakkarainen, Chairman of the Board of the Financial Supervisory Authority: "Risk weights based on the Internal Ratings Based Approach are low in Finland by international comparison, and IRB risk weights vary significantly between credit institutions."

[21] The floor will be applied in application of Article 458 CRR. The article provides for a EU process in which the Council of Ministers may oppose the decision on the initiative of the Commission. The European Systemic Risk Board (ESRB) and the European Banking Authority will give statements on this matter to the Commission. FIN-FSA will hold discussions with the EU authorities involved in the matter before a final decision of the Board of FIN-FSA on the application of Article 458 is made.

82. The announced application of a floor is an important step towards reducing the potential distortions arising from excessively low risk weights, but supplementary actions are needed to address the underlying problem, as discussed below. The application of floors for different portfolios does not address the likely underestimation of risk implied by extremely low RWAs: first of all, such a floor might be not as conservative as supposed (e.g., if the 'real' appropriate risk weight may be higher than the floor); secondly, it could incentivize forms of regulatory arbitrage: e.g., a bank with an average risk weight below the floor would have an incentive to increase it up to the floor level by expanding its portfolio towards riskier (and, consequently, more profitable) exposures.

83. In the SSM, supervisory tasks related to internal models of SIs encompass two broad groups of activities: model approvals and ongoing model monitoring (OMM). The former includes all those activities originated by a request from a supervised entity and requiring a formal decision by the SSM (new model approvals; approvals of material model changes or model extensions or changes to the roll-out plans; authorization to revert to a standard approach). The OMM includes activities triggered by the supervisor and not necessarily conducing to supervisory action, such as: follow-up of recommendations, terms and conditions from previous decisions; assessment of non-material model changes and extensions; analysis of back-testing, internal model validation reports, etc.; cross-institutions benchmarking.

84. In the SSM supervisory approach the two types of activities are clearly distinguished. JSTs are responsible for ongoing model monitoring while individual model approvals fall within the remit of the project manager designated by the JST coordinator among the JST. The SSM supervisory manual defines OMM a "permanent legal requirement" and considers it a "continuous process;" it requires the JSTs to create standard summary reports briefly describing the characteristics of the models, the degree of compliance with regulatory requirements and the possible need to apply supervisory measures. The outcome of the OMM should be integrated into the SREP at least on an annual basis.

85. As the global supervisory experience with banks' internal models shows, ongoing monitoring is an activity at risk of receiving insufficient supervisory attention. Generally model approvals attract heightened attention (and, with that, more adequate time and resources) from both the authorities – because of the need to adopt a formal decision – and the applicant – because of its interest in getting the model approved. Once a model is approved, the tension towards improving the models typically drops from the bank's side and other considerations prevail, including how to 'optimize' (i.e., minimize) risk-weighted assets; on the supervisors' side the challenge is to maintain a high level of attention (e.g., to follow up on terms and conditions accompanying the approval) while allowing specialists to join other missions and non-specialist staff to fully return to the obligations of day-to-day supervision.

86. The approach established by the supervisory manual for OMM appears appropriate, but its implementation might be affected by resource constraints. An internal review on the staffing and skills of JSTs, concluded in December 2015 and based also on the results of an internal survey, found that almost one-third of the respondents were very dissatisfied with respect to the adequacy of JSTs to perform on-going monitoring of models; the average degree of dissatisfaction was lower (14 percent of very dissatisfied) as regards the adequacy to follow up on reports by the Internal Models division (INM). The report further observed that the dissatisfaction seems less linked to the perception of inadequacy of available skills within the JST and more to other aspects, such as "the overall number of resources [which] seems to influence the JSTs adequacy to perform INM-related tasks" and, possibly, also the relative inexperience of many teams with model-related issues at the time of the survey. The assessor also found anecdotal evidence of how challenging it can be for JSTs, already very busy with day-to-day supervision, to conduct a satisfactory ongoing model monitoring and how investigations by the INM can often represent the only feasible opportunity for a JST to get an appropriate insight into the functioning of internal models in a bank and to become aware of possible shortcomings.

87. This problem highlights the urgent need for the SSM to proceed with a thorough Euro area-wide review of banks' internal models. An endeavor of this kind, announced a few times in the past, is now materializing through the ECB 'TRIM' project (Targeted Review of Internal Models), whose planning is ongoing and whose execution is expected in the next two years. The project aims at a targeted review of select issues of the most relevant internal models, especially for credit risk, selected according to established criteria of materiality and criticality.

88. The TRIM project represents a valid and extraordinary measure. It addresses the current lack of comparability between models across the SSM (largely stemming from a wide range of pre-SSM practices) and to address those situations where banks may have reduced the conservatism of their models to 'optimize' their RWAs. In this sense, the project can reinstate an adequate 'level playing field.'

89. However, the project should be accompanied by specific solutions for the 'steady state.' It is important to avoid the risk that the results achieved will get dispersed in the post-project phase. On one hand the project itself will certainly increase the degree of awareness and expertise among the specialists and also in the JSTs, thus reinforcing the capacity of the 'line' supervisors to proactively follow the evolution of internal models at the banks under their responsibility; on the other hand, if the ongoing monitoring of internal models has to be left with the JSTs, appropriate solutions will have to be devised in terms of resources, tools (e.g., through a standardization of the benchmarking exercise), processes (e.g., through a more detailed description on how banks' internal validation reports should be processed). The Internal Models division seems to be aware of the need to invest also in this direction.

Market risk

90. The EBA Guidelines on SREP specify the elements of market risk management that supervisors need to assess. These include, inter alia: market risk strategies and risk appetite; organizational frameworks; policies and procedures; risk identification, measurement, monitoring and reporting; and internal control framework.

91. The SSM manual provides guidance and questions aimed at verifying the adequacy and soundness of the market risk management process of the institutions, taking into account the relevance of their market activity. The questions are spread over four dimensions: governance, risk appetite, risk management and internal controls, and internal audit.

92. While JSTs can and do verify banks' classification of assets according to the Fair Value Hierarchy (FVH), no investigations on valuations have been conducted so far. The correctness of FVH classifications was checked mainly during the 2014 Comprehensive Assessment; JSTs generally include further checks on FVH classification in planned on-site visits, when needed. There is not, instead, a regular program to directly verify the valuation of fair-valued positions and any consequent need for additional valuation adjustments, although internal model investigations can include price verifications on selected samples, aimed at challenging banks' internal pricing models. The supervisors also have a dialogue with banks' auditors playing a role for the review of the valuation of marked to market positions and can call for external auditors/experts to perform such investigations, under the responsibility of the SSM Head of Mission.

93. The supervision of market risk at the FIN-FSA is based on the standard 'Management of market risk' (4.4c) and on the EBA SREP guidelines. It comprises the core principles for market risk management and control as well as provisions on the establishment and maintenance of these functions. This regulation is applied to all market risks associated with a supervised entity's activities, regardless of whether they can be attributed to trading book or non-trading book items or the level of trading activity. Planning of on-site investigations is risk based. Market risk has not been focus area in LSI institutions; the last market risk inspection was made in 2012. Two market risk investigations for LSIs are planned for 2016.

94. In Finland, a considerable share of derivative contracts is cleared through clearing houses. Banks are mainly exposed to one CCP, LCH Clearnet. Finnish banks have also substantial derivatives exposures towards large international investment banks. However, the bulk of derivative exposures (more than 90 percent of the whole banking system) is currently represented by the derivative book of NBF, which serves as a hub for the banking group. As part of the announced transformation of NBF in branch, the whole book will be transferred to the parent company in Sweden. Once the operation is completed, the derivative exposure of the Finnish banking system will considerably drop.

Decisions on capital

95. The CRD requires that competent authorities determine whether banks can ensure a sound management and coverage of their risks. They must intervene on supervised entities at an early stage to address relevant problems that determine an actual breach of CRD and CRR provisions or a likely breach in the next future (12 months). Among the measures that supervisors can adopt, as a decision based on the SREP assessment, there is the requirement for a bank to hold own funds in excess of its Pillar 1 capital requirements (so called Pillar 2 capital add-ons)[22] and to apply a specific provisioning policy or treatment of assets in terms of its capital requirements.

96. While the SSM regulation grants the ECB wide powers to impose supervisory measures, those assigned to the FIN-FSA by the Finnish legislation are somehow more limited. The CRD requires that competent authorities are granted a specific range of powers to impose supervisory measures, from imposing additional or more frequent reporting to restricting or limiting a bank's business and operations and restricting or prohibiting profit distributions or interest payments (art. 104 CRD). The pre-condition for the use of such powers is the breach of any provision of the same CRD of the CRR (not only the prudential requirements) or the likelihood that such a breach might occur in the following 12 months. For SIs, Article 16 of the SSMR lists all supervisory powers of the ECB.

97. In Finland the transposition of article 104 CRD can be found in different parts of the Act on Credit Institution (Act 610/2014); however, the transposition does not ensure that the FIN-FSA can actually impose supervisory measures foreseen by the CRD on LSIs. For example, the Act provides for the application of a discretionary capital add-on, but subjects such a measure to either a material deficiency in the way the bank has assessed its capital needs or to the inadequacy of the bank's own funds to cover its ICAAP estimate of its own capital needs (Chapter 1, Section 6); as the latter is the result of an internal assessment, this rule clearly is not aligned to the letter and the spirit of the CRD. While the following part of the same rule allows the imposition of a capital add-on also in case of risk that are not already covered (or not completely) by the minimum requirements (e.g., for concentration risk), its formulation is not clear and its application might lend itself to be disputed. Also, the Act seems to prevent the FIN-FSA from imposing an add-on as a way to address potential breaches of other provisions of the CRD or CRR (for example in case of material deficiencies in the internal governance) or an adjustment to provisioning for prudential purposes.

98. The decision to alter a bank's capital requirement is based on the outcome of the SREP. In case of banking groups with subsidiaries outside the euro area and of EA subsidiaries of non-EA banks, the report is shared within the supervisory college. The decision is communicated to each bank via a SREP letter, which represents a legally binding act; the letter carries the motivations that substantiate the decision. JSTs are encouraged to organize a meeting with the management body of the bank, to present it with the conclusions of the SREP and the rationale of the SREP decision.

99. The SREP process that leads to the ECB capital decisions is articulated in three main phases: preparation, evaluation and decision. During the preparation phase JSTs collect the relevant information needed to perform the SREP such as ICAAP and ILAAP reports. In the evaluation phase, JSTs assign all relevant SREP scores and prepare the draft Group Risk Assessment and the Group Liquidity Risk Assessment Reports on the basis of end year COREP data and STE data. In the decision phase, on the basis of the assessments carried out in the evaluation phase:

- JSTs prepare the draft SREP decisions;

[22] As specified by the EBA, Pillar 1 and Pillar 2 capital requirements should be a minimum to be preserved at all times based on an institution-specific assessment of the risks not covered, or fully covered, by Pillar 1 capital requirements.

- the draft SREP decisions are then submitted to the Supervisory Board for approval;
- after approval the draft SREP decisions are notified to the supervised entities and a two weeks hearing period starts;
- JSTs, in cooperation with horizontal functions, assess the comments received and, if deemed appropriate, incorporate them in the draft SREP decisions;
- draft decisions are finally sent to the Supervisory Board and thereafter to the Governing Council for final approval via non objection procedure.

100. The 2014 SREP on SIs was based on the national RAS (Risk Assessment System). As the SSM had started only at the end of 2014, no common methodology was available and the decision was taken to provisionally use the RAS developed in each participating country.

101. In 2015 a single risk assessment methodology was used for the first time for the SREP (based on 2014-end data). However, the other two relevant 'blocks' for decisions on capital (banks' ICAAPs and stress tests) were downplayed due to a perceived excessive heterogeneity in the methodologies used by banks.

102. In 2016 the ECB plans to incorporate all the relevant perspectives into its SREP assessments with reference to the capital and liquidity adequacy assessment: that of the supervisor (so called Block 1), that of the bank (so called Block 2, that encompasses the analysis of the ICAAP/ILAAP), and a forward-looking perspective (so called Block 3, through the analysis of a bank's own stress test, as compared with and challenged by the supervisory stress test).

103. In January 2016 the ECB published a note making its expectations explicit on ICAAPs and ILAAPs for 2016. In particular, in order to remediate to the generally insufficient quality of the ICAAPs and ILAAPs submitted in the previous cycle, the note explained the ECB's baseline expectations with regard to nine ICAAP areas, from governance to the definition of stress-test scenarios.

104. As regards the communication with banks on the outcome of the SREP, the SSM policy is evolving. Currently the overall SREP score can be shared by the JSTs with the banks they supervise informally, within their ongoing dialogue. This policy might be reconsidered. Although there is no automatic link between the SREP scores and the Pillar 2 measure applied to a bank, an improved communication of SREP scores (without disclosing the underlying methodology) could mitigate the banks' uncertainty about the supervisor's stance and generally advance the supervisor-bank dialogue.

105. The approach towards disclosure to the public is also subject to possible changes. In 2015 banks were required not to disclose the content of the SREP, unless compelled by national laws or regulation (e.g., regarding public disclosure of relevant facts by listed banks). This might change, following the opinion issued by EBA in December 2015: competent authorities should consider requiring banks to disclose their capital requirements when relevant for the determination of the maximum distributable amount of profits or should at least not prevent or dissuade any bank from disclosing this information. This information is relevant both for shareholders and certain bondholders (as it might determine restrictions on the distribution of dividends and on the payment of coupons to holders of AT1 instruments).

106. Disclosure to the public could also be improved by communicating the state of banks' capitalization in terms of capitalization indices, in place or beside the traditional capital ratios. As a consequence of the international regulatory response to the global financial crisis, subsequent layers of capital add-ons and/or buffers have been stacked on top of the minimum requirements: apart from the Pillar 2 add-ons (that already existed under Basel II but were generally considered non-binding), now the own funds of a bank must cover also the capital conservation buffer, the counter-cyclical buffer (when implemented), the G-SIB buffer (for G-SIBs),[23] and, as a specificity of the EU, possibly also the systemic buffer (art. 133 CRD) and the O-SII buffer (art. 131 CRD, applied to other systemically important banks).[24]. As a result of this stratification of capital requirements, the traditional capital ratios, calculated as the ratio of own funds to the Pillar 1 risk-weighted assets, are becoming increasingly less meaningful and transparent, possibly conducive to misleading interpretations (e.g., when a bank with a high and undisclosed Pillar 2 add-on is perceived as well-capitalized). Moving to an index approach, calculated as the ratio of own funds to the whole of the capital requirements (as for the LCR), would provide a clearer and more straightforward representation of a bank's solvency: its health would be simply measured by how much above 100 percent its capital index lies.

107. In the current situation Finnish banks' capitalization appears adequate, but supervisors need to remain vigilant with respect to factors that could lead to overestimating capital levels and underestimating risk-weighted assets. Apart from the possibility of a deterioration of loan portfolios as a consequence of negative macrofinancial developments and the potential underestimation of risks by IRB banks, another situation that needs to be monitored is the potential impact of the draft law capping Finnish municipalities' tax-raising powers: while the impact on MF is, of course, the most relevant, the other banks could be affected as well, depending on the size of MF securities in their portfolios.

E. Liquidity and Funding

108. The regulatory and supervisory framework for liquidity and funding risk has improved since the last FSAP, but certain vulnerabilities persist and require greater attention. The implementation of LCR and NFSR requirements in the EU, as well as additional monitoring metrics, will provide a clearer, more robust, and more regular picture of banks' liquidity and funding risks.

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[23] Nordea AB (Sweden) is a designated Global Systemically Important Bank (G-SIB) and is subject to a 1 percent CET1 surcharge.

[24] Based on a July 2015 decision, the FIN-FSA has designated NBF, OP, DB, and MF as O-SIIs and has imposed an additional capital requirement - to be covered by CET1 capital – of 2 percent for NBF and OP and 0.5 percent for the other two banks.

However, certain longstanding issues persist (the high reliance on wholesale funding) and others are emerging (sizable crossholdings and concentration of covered bonds).

109. The SSM requires banks to report their Liquidity Coverage ratio (LCR) and other information on liquidity and funding on a quarterly basis. Starting in the third quarter of 2016, these reports will be received on a monthly basis. The liquidity position is monitored and assessed at least annually as part of the SREP. Limits to the mismatch of assets and liabilities are achieved partially through the LCR and more comprehensively through the future application of binding NSFR requirements. In addition, supervisors may apply additional requirements above the minimum as part of the outcome of the SREP process.

110. The quality of liquidity risk management controls, including contingency planning, is covered at least annually through the SREP assessment. Supervisors cover a range of topics, from basic compliance checks to more technical aspects of liquidity risk management. On-site inspections may be performed to conduct a more detailed assessment of the functioning of the key controls. The on-site activity is supported by a comprehensive and separate methodology.

111. As for capital, the analysis of risks to liquidity and funding encompasses three different perspectives: the supervisory perspective, based on the results of the RAS (which elaborates a number of indicators, including the LCR, to produce an automatic score); the bank's perspective, based on its internal assessments of liquidity adequacy (ILAAP); and a forward-looking perspective, based on the results of the bank's own stress-test, compared with (and challenged by) the results of the supervisory stress tests. The standardized stress scenario used to evaluate liquidity buffers and resilience to shocks is applied across all SIs, which allows benchmarking of the results. The scenario incorporates retail and wholesale stresses.

112. Finnish LSIs must comply with the FIN-FSA standard "Management of Liquidity Risk" (4.4d). It contains a number of requirements concerning the liquidity strategy, liquidity risk management, controls and procedures, liquidity buffer, stress testing and scenarios, contingency funding plan, and disclosure of information. Liquidity risks are monitored and assessed annually by the FIN-FSA as part of the SREP and through a quarterly monitoring report. An ongoing project at the FIN-FSA aims at developing several stress tests/tools, including, for example, a LCR sensitivity tool, a survival horizon tool and a NSRF sensitivity tool. On-site inspections may be performed on specific topics pertaining to liquidity risk management.

113. The FIN-FSA initiated a thematic review on LCR and ILAAP in May 2016. It aims at verifying banks' compliance with the regulation on liquidity risk, assessing the quality of liquidity management, establishing a common understanding of ILAAP in the industry and improve its quality. It could be followed by supervisory visits or inspections, if needed, and feed the SREP, including for determining any additional liquidity requirements.

114. The LCR requirement is in force in the EU since October 2015. It is applied at consolidated and individual level and subject to phase-in (from 70 percent of the requirement as of January 2016 to 100 percent from January 2018). The commission delegated regulation (EU) 2015/61

(DA) supplements the CRR with regard to the liquidity coverage requirement and provides details. The requirement follows the LCR standard set by the BCBS broadly, but with a number of divergences, which are mostly less conservative than the BCBS and as a result improve the reported ratios. In particular, the definition of High Quality Liquid Assets (HQLA) is considerably wider:

a. covered bonds rated AA– or above (and meeting certain further requirements) are included in Level 1 HQLA with a 7 percent haircut and a cap of 70 percent (DA Article 10); if rated between A– and A+ they are eligible for level 2A with a 15 percent haircut; in the Basel standard covered bonds rated AA– or above are eligible only as Level 2A HQLA (which, in turn, can represent no more than 40 percent of the overall HQLA); also, they are subject to a 15 percent haircut;

b. non-externally rated covered bonds are included into Level 2B HQLA with a 30 percent haircut (DA Article 12);

c. assets and representing claims to or guaranteed by the central government, the central bank, regional governments, local authorities or public sector entities (PSEs) of a Member State are included in Level 1 HQLA even if they are not marketable securities, as required by the Basel standard (DA Article 10); and

d. instruments from securitization of auto, SME and consumer loans are included in Level 2B HQLA (DA Article 13), while in the Basel standard residential mortgage backed securities are the only securitization instruments eligible as Level 2B.

115. Treatments that are more conservative than the Basel rule include application of 15–20 percent run off rates for certain retail deposits. Also, the 3 percent outflow rate for stable retail deposits cannot be applied during the phase-in period.

116. Nonetheless, the net effect of the EU deviations from the Basel standard is a loosening of the requirement. According to the calculation by the EBA (EBA 2014 LCR IA Report, December 2014), these deviations lead to increase in LCR of 13.9 percentage points for all the sample banks (322) and a decline in the number of banks failing to meet the 100 percent LCR from 74 to 17. The analysis shows that the impact from the increase in the HQLA 2B instruments is by far the biggest.

117. The sizable holdings of covered bonds, averaging around 30 percent of Finnish banks' liquid assets, represent a potential vulnerability. Finnish banks currently show sound levels of LCR, that they are required by the supervisors to calculate by currency, at least for the most significant currencies. However, as expected, the more generous eligibility of covered bonds in the liquidity buffer allowed by the EU regulation provides an incentive for banks to stockpile liquidity in this form. While covered bonds are generally a very solid and liquid form of investment, excessive concentration on a single type of product and on a restricted range of issuers (mostly from the Nordic area), in certain cases on a single issuer (even above 95 percent), increases the banks' exposure to extreme – but not implausible – events.

118. The high level of covered bonds cross-holding in the Nordic area could become a particular source of contagion should a major correction in house prices materialize in the region and undermine market confidence in the otherwise solid covered bond sector. This risk does not appear to have been specifically addressed so far. Given its cross-border nature, it lends itself to a coordinated regional analysis and, if needed, action by the relevant supervisors (e.g., through collaboration in the supervisory colleges or macroprudential fora). The imposition of concentration limits on covered bonds should be considered.

119. The intense issuance of covered bonds also represents a source of potentially significant asset encumbrance, that the authorities should continue to monitor and prepare to specifically address. Current reporting already allows to monitor the evolution of asset encumbrance; however, a common methodology should be created to establish what levels of encumbrance should raise an alarm and which specific supervisory action should ensue.

120. The high reliance of banks on wholesale funding remains a characteristic of the Finnish banking system, as already observed at the time of the previous FSAP. The loan/deposit ratio has continued to decline in the past years, though it is still higher than 120 percent. Given the limited room for expanding the deposit base (especially in the current low interest rate environment) supervisors have been engaging banks on their risk management practices, by requiring: a wider diversification of funding in term of counterparts, maturities, and currencies; monitoring of intragroup liquidity flows; extension of their liquidity survival horizon; preparation of adequate contingency plans. Particular attention has been paid to a reduction in the short-term component of wholesale funding. The share of foreign counterparts in wholesale funding, instead, is very high (78 percent for the whole system), though this is partly due to large intragroup exposures of the major subsidiaries and branches of foreign banks.

121. The process and the conditions for the application of quantitative and qualitative measures on liquidity are the same as for the decisions on capital; however, also because of the recent implementation of LCR in the EU (October 2015), the practices are not well established yet. Also, the CRR granted EU member states the option to speed up the phase-in of LCR (which started from a minimum requirement of 60 percent and is meant to reach 100 percent only in 2018); this means that currently the minimum requirement differs across the SSM. The ECB has amended its supervisory manual to refine the methodology supporting the decisions on liquidity.

F. Enforcement and Sanctioning

122. The enforcement and sanctioning framework has been reinforced, though its functionality is yet to be tested in light of the complexity of the SSM arrangements. The 2010 FSAP had recommended an improvement of powers to impose administrative fines and/or penalty payments and an increase of maximum amounts. These powers have been expanded in the national legislation, including through CRD transposition. The SSM framework for enforcement and sanctioning is based on a combination of powers assigned either to the ECB or the National

Competent Authorities (NCAs), with the latter not being fully harmonized. Where the ECB lacks the powers to directly impose enforcement measures or sanctions on banks, it can request or instruct the NCAs to act, based on the powers available to them. This complex arrangement has not been put to the test so far in Finland.

123. In the SSM any identified breach leads to an action, that can be based on supervisory powers, enforcement powers, and sanctioning powers.

- The initiative to exercise supervisory powers is in the remit of JSTs and is aimed at ensuring that banks address relevant deficiencies at an early stage: for SIs these powers are granted to the ECB by Art. 16 SSMR, while for LSIs they rest on the transposition of Art. 104 CRD (for Finland in the Act on Credit Institutions).
- Enforcement powers are aimed at compelling a bank to comply with prudential requirements laid down in supervisory decisions or regulations: all enforcement actions are initiated by referring the identified breach to the Enforcement and Sanctions Division (ESA), which assesses the case to decide whether to close it or continue the enforcement procedure.
- Sanctioning powers are used to punish a bank in case of non-compliance with prudential requirements; they are initiated by a 'referral' of the case to the ESA division, which acts as the ECB's investigating unit and assesses it and decides whether to close it or to proceed.

124. Some enforcement measures are directly available to the ECB. These are the periodic penalty payments (Art. 18(7) SSMR), which can be imposed in case of on-going breaches of ECB decisions or regulations, and those tools qualified as enforcement measures under national laws transposing relevant directives. They can be imposed on SIs and, in specific cases, also on LSIs and natural persons (see table 2).

125. To the extent necessary to carry out the supervisory tasks conferred on the ECB, all the pure national enforcement measures not related to the transposition of relevant directives are available to the ECB only indirectly. In Finland, for example, the FSA can impose conditional fines on a bank that does not comply with an FSA decision or regulation or with rules governing its authorization or applicable to its operations (Section 33a of the Act on the FIN-FSA). The ECB can instruct the FIN-FSA to impose such a measure.

126. In the case of SIs, the ECB has direct sanctioning powers only for pecuniary sanctions on legal persons for breaches of ECB decisions or regulations or of directly applicable EU law (e.g., CRR). For these same breaches, non-pecuniary sanctions and sanctions on natural persons are to be imposed by NCAs, upon ECB request. Similarly, NCAs impose all types of sanctions (to both legal and natural persons) upon ECB's request in case of breaches of national laws transposing the CRD. For LSIs, the sanctioning power rest with the NCA.[25]

[25] The ECB may impose PPPs and fines on LSIs for breaches of ECB decisions or regulations imposing obligations vis á vis the ECB.

Table 3. ECB/NCA Sanctioning Powers			
Infringement / Sanction		Significant Supervised Entities (SSE)	
		Entities	Natural persons
Directly applicable EU law	Pecuniary	ECB (Art. 18.1 SSMR)	
	Non-pecuniary	NCA (only at ECB request) (Art. 18.5 SSMR)	
National law implementing EU Directives	Pecuniary		
	Non-pecuniary		
ECB regulations and decisions	Pecuniary	ECB (Art. 18.7 SSMR)	
	Non-pecuniary	NCA (only at ECB request) (Art. 18.5 and 18.7 SSMR)*	
National law: non-ECB tasks	Pecuniary	NCA	
	Non-pecuniary		

127. **Any alleged breach referred is investigated by the ESA Division.** Once the investigation is completed, and before a proposal for a complete draft decision is prepared and submitted to the Supervisory Board, the investigating unit notifies the supervised entity concerned, in writing, of the findings under the investigation carried out. The supervised entity is informed of its right to make submissions in writing to the investigating unit on the facts and objections and of its right to have access to the ECB's file. The investigating unit may also invite the supervised entity to attend an oral hearing. The parties subject to investigation may be represented and/or assisted by lawyers or other qualified persons at the hearing.

128. **After the hearing, if the investigating unit still considers that an administrative penalty should be imposed, a proposal for a complete draft decision is submitted to the Supervisory Board.** The Supervisory Board has a range of possibilities: from returning the file to the investigating unit to request additional information, if deemed incomplete; to adopting the proposal of the investigating unit or a different draft decision in case of some disagreement with the investigation unit proposal. The complete draft decision adopted by the Supervisory Board is proposed to the Governing Council, which can approve or object the decision.

129. **Two appeal procedures are available with respect to individual supervisory decisions taken in application of the SSM Regulation, the CRR and other rules (in particular those**

deriving from the national transposition of EU directives). First, a request for review to the Administrative Board of Review (ABoR), an independent body which carries out internal administrative reviews of the ECB's supervisory decisions.[26] As an outcome of the review procedure, the ABoR must adopt an opinion on the review no later than two months from the date of receipt of the request for review. Based on the opinion of the Administrative Board, which is not binding, the Supervisory Board decides whether to make a proposal to the Governing Council to abrogate the contested decision, to replace it with a decision of identical content or to replace it with an amended decision.

130. The legality of ECB individual supervisory decisions intended to produce legal effects may also be reviewed by the Court of Justice of the European Union. The Court can only verify the legality of ECB decisions, without opining about their merit.

131. As regards the enforcement and sanctioning framework in Finland, the 2010 FSAP had recommended an improvement of powers to impose administrative fines and/or penalty payments and an increase of maximum amounts. These powers, based on the Act on the Financial Supervisory Authority, have been expanded in the Finnish legislation and are further complemented by those granted to the supervisory authorities by the law transposing the CRD.

132. The administrative sanctions include administrative fines, public warnings, and penalty payments.

- Administrative fines may be imposed on anyone who willfully or negligently fails to comply with or violates the specific obligations laid down in the FIN-FSA Act or in other legislation governing financial markets; in practice, administrative fines are imposed for neglect of minor cases e.g., to companies which have failed to submit the regular reports by a given deadline.[27]
- Public warnings may be issued to a supervised entity or other financial market participant that willfully or negligently violates the provisions governing financial markets or the regulations issued thereunder, but only in cases other than the offences covered by administrative fine and penalty payment.

[26] The ABoR is composed of five members and two alternates, all of whom are individuals of high repute with a sufficiently high level of experience in the fields of banking and other financial services. The members of the ABoR act independently and in the public interest and are not subject to instructions by the ECB. All its members and alternates made public declarations of commitments and interests which were published on the ECB's website.

[27] The administrative fine payable by a legal person shall amount to no less than EUR 5,000 and to no more than EUR 100,000. The administrative fine payable by a natural person shall amount to no less than EUR 500 and to no more than EUR 10,000.

- Penalty payment is the administrative sanction for the most serious offences: it can be imposed on anyone who willfully or negligently fails to comply with or violates the specific provisions or decisions as referred to in the FIN-FSA Act or in other legislation.[28]

133. Time limits apply to the exercise of the FSA sanctioning powers. According to the FIN-FSA Act section 42 an administrative fine shall not be imposed or a public warning issued, if this has not been done within five years of the day on which the act or omission occurred, or in respect of a continued act or omission, within five years of the day on which the act or omission terminated. The FIN-FSA may not impose a penalty payment, or make a proposal for imposition of a penalty payment to the Market Court, if this has not been done within ten years of the day on which the act or omission occurred or, in respect of a continued act or omission, within five years of the day on which the act or omission terminated.

134. The administrative sanctions imposed in the recent past by the FSA have focused mainly on issues related to market supervision and conduct of business rules. The FSA has not imposed any sanctions to individual persons (excluding insider register notifications, market supervision related violations and offences).

135. The SSM enforcement and sanctioning framework is a complex arrangement, requiring the coordination of powers available to the ECB and to each of the 19 NCAs participating in the SSM. The ECB needs to acquire knowledge of the specificities of the enforcement and sanctioning framework in each EA jurisdiction. This complex arrangement has not been put to the test so far for Finnish banks. At the time of the FSAP mission no enforcement measures or sanctions had been imposed by the ECB on any SI in the SSM.

136. The ECB has initiated the collection of information on the powers available in each jurisdiction, with the aim of creating and maintaining a regulatory database; this project is on-going. Once finalized, it should facilitate the ECB task of preparing to use NCA powers indirectly, should the need arise.

G. Nordea Transformation

137. A major change to the Finnish financial markets, and to the responsibilities and powers of the ECB and FIN-FSA, is the planned conversion of Nordea Bank Finland, the largest bank in the country, to a branch of Sweden's Nordea Bank AB. With the conversion, the primary supervisor of Nordea's operations in the branch will shift to the Swedish FSA, which supervises Nordea AB. While Nordea has indicated that it does not expect to change its business model in Finland, it will shrink its Finnish balance sheet. The derivative book in NBF, which in 2014 exceeded

[28] The penalty payment shall amount to no more than 10 percent of the turnover of the legal person for the year preceding the act or omission, and to no more than EUR 10 million. The penalty payment imposed on a natural person shall amount to no more than 10 percent of his or her income, according to the latest tax assessment, but to no more than EUR 100,000. If the above mentioned of-fences are based on provisions in the Act on Credit Institutions chapter 20 section 1, the penalty payment shall amount to no more than 10 percent of the turnover of the legal person and the penalty payment imposed to a natural person shall amount to no more than EUR 5 million.

€100 billion, will be moved to NBAB. Nordea plans to set up a mortgage lending subsidiary in Finland (a necessary step due to covered bonds that were issued in Finland). Even after the reduction in Finnish operations, Nordea is expected to continue to be one of the two largest banks in Finland.

138. A key issue for FIN-FSA (and for the ECB) going forward, if branchification proceeds, will be the role they play, as host supervisors, in monitoring and supervising the Nordea branch, in cooperation with the home supervisor, the Swedish FSA. For cross-border branching within the EU, CRD assigns supervisory responsibility to the home supervisor. CRD does not appear to have fully anticipated situations in which a branch is systemically important and of critical importance to the host country and its supervisor.

139. If a branch is considered "significant," with a deposit market share in excess of 2 percent, CRD provides for an increased level of coordination between the host supervisor and the home supervisor. But the role of the host supervisor, particularly with respect to information on the health of the parent and supervisory decisions that might affect the branch, are limited.

140. There is no category under CRD for systemically important branches that provide critical financial services to the national economy of the host supervisor. While CRD may not have anticipated an active supervisory role by the host supervisor in the case of small cross-border branches, when such a branch is one of the largest banks in the host country, it poses a vulnerability to the host country's financial stability. In such cases, the host supervisor should remain current on the financial performance and risks posed to the host economy by both the branch and the parent company. Failure to do so would mean that the host supervisor was not fulfilling its responsibilities to safeguard its domestic banking system.

141. Over the near-term, consistent with CRD, Finland and the ECB should enter into mutually-agreed arrangements with home supervisors of branches operating in Finland that are systemically important. Negotiations are currently under way to agree on a comprehensive MOU that provides that FIN-FSA and the ECB with full access to information related to the operations and financial health of the branch. It is recommended that the MOU include items such as customized reports related to particular risks of the branch; access to annual auditor's findings for the branch; and information on the liquidity requirements and positions of the parent bank.

142. The MOU under negotiation also contemplates that FIN-FSA/ECB will be actively engaged in the supervision of the systemically important branch and its parent through the relevant supervisory college, chaired by the home supervisor. While the home supervisor would retain responsibility for the prudential supervision of the bank, the FIN-FSA and ECB would be involved in the assessment of the institution's risk. FIN-FSA/ECB should participate in SEP planning with respect to the branch activities and have direct interaction with management of the parent bank and business heads. FIN-FSA/ECB should be in a position to assess the adequacy of the institution's capital and liquidity and should be consulted prior to any decision by the home supervisor related to liquidity and capital requirements. FIN-FSA/ECB should also participate in recovery planning covering critical economic activities of the branch, liquidity planning, and the resolution college. The

FSA should have its own strategy to deal with a situation in which a systemically important foreign branch is unable to continue to provide essential services to its Finnish customers.

143. Under the MOU, FIN-FSA and the ECB should also be given the opportunity to participate in on-site inspections of activities at the group level, which might be relevant to the branch's operations. FIN-FSA/ECB should have the ability, upon notification to the home supervisor, to carry out on a case-by-case basis, on-the-spot checks and inspections of the activities carried out by the branches. Periodic meetings with branch management to be informed of the branch's performance and planned future activities should be held.

144. Fortunately, the Nordic country supervisors have a long tradition of working together in the supervision of pan-Nordic banks. Sweden, as home supervisor, is currently working with the other Nordic supervisors and the ECB to develop a supervisory memorandum of understanding covering large significant branches that would provide host supervisors with enhanced powers regarding access to information and supervisory engagement with the branches and parent banks. This effort will be organized around the core supervisory college for each banking group.

145. Notwithstanding the good track record of supervisory collaboration in the Nordic area, a mutually-agreed arrangement is not binding and, therefore, may be not sufficient to address critical situations. The experience has demonstrated that cross-border collaboration can be severely put to the test in times of crisis, even between authorities operating in well-integrated areas. No host supervisor, including the ECB, should be in a position where it has only minimal authority to monitor and address vulnerabilities in institutions that pose a risk to the financial stability and well-being of the national or regional financial systems. For branches that are systemically important in a host country, consideration should hence be given to how the CRD might be amended to retain the original objective of encouraging the free flow of financial services within the EU while, at the same time, providing host supervisors with additional authority over systemically-important institutions, in close collaboration with the home supervisor.

RECOMMENDATIONS

A. Main Recommendations

146. The authorities should ensure that the Finnish legislation grants the FIN-FSA all the powers it needs according to the CRD for the supervision of LSIs. The CRD requires that competent authorities are granted a specific range of powers to impose supervisory measures, from imposing additional or more frequent reporting to restricting or limiting a bank's business and operations and restricting or prohibiting profit distributions or interest payments (art. 104 CRD). In Finland the transposition of article 104 CRD does not ensure that the FIN-FSA can actually impose supervisory measures on LSIs at the same conditions set in the CRD. For example, the Act provides for the application of a discretionary capital add-on, but subjects such a measure to either a material deficiency in the way the bank has assessed its capital needs or to the inadequacy of the bank's own funds to cover its ICAAP estimate of its own capital needs. Also, the Act seems to prevent the

FIN-FSA from imposing an add-on as a way to address potential breaches of other provisions of the CRD or CRR (for example in case of material deficiencies in the internal governance).

147. To avoid the appearance of the government infringing on the independence of the FSA, future Board members should be selected among experts who are not part of the government. From the perspective of BCP 2, related to operational independence of supervisors, the role of the Board, with officials from Ministry of Finance and Ministry of Social Affairs serving as board members, might create the appearance of a lack of independence, though the mission is unaware of any inappropriate interference by the Board in the decision made by the FSA.

148. The FSA should gradually increase the number of supervisory staff to accommodate the demands of the ECB for FSA staff on JSTs and Inspection teams, and in response to the more intense supervision expected for LSIs.

149. Legal protection of the FSA's officials and staff should be strengthened. Finnish financial sector legislation does not include clauses to provide officials and staff of the agencies legal protection for actions and omission in good faith in the exercise of their official duties. The Finnish equivalent of "good faith" will need to be determined and enshrined in legislation. Then operational arrangements will be required to make this protection effective.

150. Finland and the ECB should finalize the ongoing negotiations with Sweden with respect to MOUs covering systemically important significant branches to provide them with greater access to information and enhanced powers regarding supervisory engagement with the branches and parent banks. This effort should be organized around the core supervisory college for each banking group. The FSA should also develop its own contingency plan to deal with a situation in which a systemically important foreign branch is unable to continue to provide essential services to its Finnish customers.

151. Consideration should be given to how the CRD might be amended to retain the original objective of encouraging the free flow of financial services within the EU while, at the same time, providing host supervisors with additional authority over systemically-important institutions, in close collaboration with the home supervisor. Determination of whether a branch is systemically important, which falls under the mandate of the European Banking Authority, might be based on the same metrics relative to size applied by the ECB to determine if an institution is significant – assets in excess of €30 billion and the economic importance of the entity to the specific country or EU economy.

152. To address the low and decreasing level of Finnish advanced model banks' risk densities, the authorities should proceed with the announced comprehensive review of banks' internal models and devise, for the future, a sustainable form of ongoing model monitoring to prevent banks from reducing again the degree of conservatism in their models. The need to proceed with a thorough Euro area-wide review of banks' internal models, evident since the beginning of the SSM, has finally found a response in the 'TRIM' project, whose planning is ongoing and whose execution is expected in the next two years. The project aims at a targeted review of select issues of the most relevant internal models, especially for credit risk, selected according to established criteria of materiality and criticality. The project represents an important opportunity to address the current lack of comparability between models across the SSM and to address those situations where banks may have reduced the conservatism of their models to 'optimize' their RWAs. In this sense, the project can reinstate an adequate 'level playing field,' but specific solutions need to be created to ensure that the results achieved can be maintained in the post-project phase, through the ordinary, ongoing monitoring of internal models.

153. The authorities should continue to monitor banks' diversification of their funding sources and analyze, within the SSM and in collaboration with the other supervisors in the Nordic area, the risks possibly stemming from the crossholding of bonds, in particular covered bonds. Finnish banks continue to rely extensively on wholesale funding, as noted in the 2010 FSAP; while supervisory action has managed to mitigate the problem (e.g., by pressing banks to better balance their wholesale funding in terms of maturities and reduce the share of liabilities expiring in the short term), many banks remain heavily exposed to the risk of a freezing of unsecured wholesale funding. Also, part of this wholesale funding stems from the issuance of covered bonds, with banks also holding covered bonds (issued by other banks) on the asset side, as part of their highly liquid buffers. The high level of covered bond cross-holdings between banks (especially when looking at the wider Nordic area) could become a particular source of concern (for possible domino effects), should a drastic correction in house prices materialize in the region, as that could dent market confidence in the otherwise solid covered bond sector. This risk does not appear to have been specifically addressed so far; given its cross-border nature, it lends itself to a combined analysis and – if needed – action by the relevant supervisors. Within the SSM this analysis could be performed through an appropriate exploitation of the Securities Holding Statistics database.

B. Other Recommendations

154. The authorities should continue to closely monitor banks' loan portfolios to verify the evolution of renegotiated loans and continue to probe the accuracy of banks' asset classification according to EBA definitions. After the 'loan payment holidays' campaigns ended in Q3/2015, volumes of renegotiated loans have remained at around four times the pre-campaign level. While the general policies and practices for the recognition of forborne and non-performing exposures have been the object of some on-site inspections, the reason for this persistently high level of renegotiated loans has not been investigated so far.

155. The ECB should update its on-site methodology to ensure that the samples of loan files analyzed during inspections (especially those focusing on banks' asset classification policies and practices) are selected according to statistically robust criteria. With too limited and/or non-statistically drawn samples, no extrapolation is generally possible. Consequently, it is not possible to calculate a level towards which the supervisor would expect a given ratio (e.g., NPL ratio or ratio of forborne loans over total loans) to converge. The availability of such a benchmark would facilitate the follow-up activity, by allowing to monitor the situation through the analysis of a bank's periodical reports.

156. The Finnish authorities should implement a regular data collection of individual loan files to better support the analysis of credit risk. At least for corporate lending, individual loan information will be available through the EA-wide AnaCredit project, but the lack of granular data on household loans limits the possibility for the supervisor to closely monitor the evolution of certain phenomena (like the recent explosion of renegotiated loans). This may require changes to the laws.

157. The authorities should establish a regular program to directly verify the correct classification valuation of fair-valued positions and any consequent need for additional valuation adjustments in banks with consistent amounts of Level 2 and 3 assets. While JSTs can and do verify banks' classification of assets according to the Fair Value Hierarchy (FVH), no investigations on valuations have been conducted so far. The correctness of FVH classifications was checked mainly during the 2014 Comprehensive Assessment; JSTs generally include further checks on FVH classification in planned on-site visits, when needed.

158. The waiver that can be granted, according to the CRD, to the banks that are part of a financial conglomerate and hold participations in insurance companies has implication on the loss absorbency capacity of beneficiary banks' capital and needs to be closely monitored. While perfectly legitimate under the EU legislation, the exemption implies reliance on a source of capital that is not entirely free to absorb losses arising in the banking side of the conglomerate. The waiver has been granted to one Finnish banking group part of a conglomerate.

159. The implications of the announced draft law restraining municipalities tax-raising powers, significantly affecting the business model of Municipality Finance, must be analyzed also for its impact on the other banks.

160. The ECB should ensure that the need for standardization of the supervisory methods and techniques does not distract energy, time and resources from more risk-focused tasks. To ensure comparability across banks and consistency and accountability across the SSM – but also as a way to foster a convergence in approaches and styles between supervisors with completely different backgrounds –the methodology rests on a high degree of standardization and formalism (e.g., in the checklists that inspectors are required to use). While a certain degree of standardization is essential to establish a common language in such a new, vast and multicultural organization, the risk should be avoided of a drift towards an excess of compliance-based techniques.

161. The ECB should constantly strive to improve the communication with the banks, including with respect to the outcome of the SREP. The banks observe that whenever the authorities provide feedback (for example at the end of horizontal reviews) it generally proves very helpful, but that communication with the supervisors is not always satisfactory: for example, a better explanation of the purpose and final use of data collections is sometimes lacking, while it would help them to better meet the supervisors' requests. Also, the communication of SREP scores (without disclosing the underlying methodology) could mitigate the banks' uncertainty about the supervisor's stance and generally improve the supervisor-bank dialogue.

162. Improvements should also be sought in the external communication strategy, to further highlight the specificities of the SSM, especially as regards the difference between SIs and LSIs. The experience shows that the larger public struggles to fully understand the division of responsibilities between different supervisory agencies and, in the case of the SSM, might tend to assume that NCAs continue to be responsible for SIs.

163. The authorities should follow the EBA opinion on the maximum distributable amount and require banks to disclose their total capital requirements (Pillar 1 and 2) when relevant for the determination of the maximum distributable amount of profits. This information is relevant for both shareholders and AT1 bondholders (as it might determine restrictions on the distribution of dividends and coupons). When deciding in favor of disclosure, the authorities should also carefully weigh the potential disadvantages (e.g., in a situation of tension in the markets, the potential reaction of market participants to the communication of high capital add-ons on banks with tiny capital buffers).

164. The state of banks' capitalization could be reported and communicated in terms of capitalization indices, in place or beside the traditional capital ratios. As a consequence of the international regulatory response to the global financial crisis, subsequent layers of capital add-ons and/or buffers have been stacked on top of the minimum requirements. As a result of this stratification of capital requirements, the traditional capital ratios, calculated as the ratio of own funds to the Pillar 1 risk-weighted assets, are becoming increasingly less meaningful and transparent, possibly conducive to misleading interpretations (e.g., when a bank with a high and undisclosed Pillar 2 add-on is perceived as well-capitalized). Moving to an index approach, calculated as the ratio of own funds to the whole of the capital requirements (as for the LCR), would provide a clearer and more straightforward representation of a bank's solvency: its health would be simply measure by how much above 100 percent its capital index lies.

Appendix I. Summary Analysis of Selected BCPs

Principle 1: Responsibilities, objectives, and powers	
An effective system of banking supervision has clear responsibilities and objectives for each authority involved in the supervision of banks and banking groups.[29] A suitable legal framework for banking supervision is in place to provide each responsible authority with the necessary legal powers to authorize banks, conduct ongoing supervision, address compliance with laws and undertake timely corrective actions to address safety and soundness concerns.	
Description	In the Single Supervisory Mechanism (SSM), responsibilities for banking supervision are shared between the European Central Bank (ECB) and the national competent authorities of the participating member countries (NCAs). The ECB is directly responsible for the supervision of the significant institutions (SIs), while the direct supervision of less significant institutions (LSIs) is in the remit of the NCAs, under the oversight of the ECB. The FIN-FSA is the Finnish NCA. The objectives of the ECB as a supervisory authority are stated in the SSM Regulation (Art. 4); the same regulation also specifies the tasks assigned to NCAs and the terms of the cooperation with the ECB. The Act on the FIN-FSA defines the responsibilities and objectives of the FIN-FSA. The powers to authorize banks, conduct ongoing supervision, verify banks' compliance with the laws and undertake timely corrective actions are available to the ECB; applications are to be submitted to the NCA of the Member State where the credit institution is to be established in accordance with the requirements set out in relevant national law. The way the Capital Requirements Directive (CRD) has been transposed in the Finnish legislation does not ensure that the FIN-FSA can actually impose supervisory measures on the same conditions set in the Directive.
Principle 2: Independence, accountability, resourcing and legal protection for supervisors	
The supervisor possesses operational independence, transparent processes, sound governance, budgetary processes that do not undermine autonomy and adequate resources, and is accountable for the discharge of its duties and use of its resources. The legal framework for banking supervision includes legal protection for the supervisor.	
Description	The ECB's independence is ensured by Article 130 of the Treaty on the Functioning of the European Union and extends to its supervisory tasks, as stated by Article 19 of the SSM Regulation.

[29] In this document, "banking group" includes the holding company, the bank and its offices, subsidiaries, affiliates and joint ventures, both domestic and foreign. Risks from other entities in the wider group, for example non-bank (including non-financial) entities, may also be relevant. This group-wide approach to supervision goes beyond accounting consolidation.

	Even though the FIN-FSA is administratively subordinated to the Bank of Finland, it is independent in its decision making. However, the composition of the Board, with officials from Ministry of Finance and Ministry of Social Affairs serving as board members, creates the appearance of a lack of independence, though there is no evidence of actual government interference. The processes for the appointment and removal of the heads of both the ECB and the FIN-FSA and of the members of their governing bodies are transparent. The internal governance of the ECB and the SSM is laid down in the SSM Regulation, the ECB Rules of Procedure and the Rules of Procedure of the Supervisory Board; for the FIN-FSA the relevant legal text is represented by FIN-FSA's Rules of Procedure. The ECB resources are financed via a supervisory fee to be borne by the entities subject to the ECB's supervision. The budgetary authority of the ECB is vested in its Governing Council. The original headcount for the ECB supervisory functions has proved to be insufficient with respect to its tasks. Therefore, in September 2015 the Governing Council took the decision to augment the SSM-related headcount over the next two years. ECB staff are immune from legal proceedings in respect of acts performed by them in their official capacity, including their words spoken or written. Operations of the FIN-FSA are financed through fees collected from the supervised entities and a contribution from the Bank of Finland (5 percent). Currently, a working group, led by the Ministry of Finance, assesses the need for updating the law on the financing of the FIN-FSA, also in view of the implications, for the FIN-FSA fee collection, of the upcoming transformation of Nordea Bank Finland into a branch of the Swedish parent. The headcount of the FIN-FSA has been stable and somewhat decreasing for several years and it is expected to decrease slightly in the next years; this is proving to be a constraint on the FSA efforts to adapt to the more intense, intrusive and resource-intensive supervisory approach of the SSM on SIs and to reinforce supervisory intensity on LSIs, as well as increasing demands on macroprudential policy analysis, contingency planning and crisis management. The Finnish financial sector legislation does not include clauses to provide officials and staff of the FIN-FSA legal protection for actions and omission in good faith in the exercise of their official duties.

Principle 8: Supervisory approach	
An effective system of banking supervision requires the supervisor to develop and maintain a forward-looking assessment of the risk profile of individual banks and banking groups, proportionate to their systemic importance; identify, assess and address risks emanating from banks and the banking system as a whole; have a framework in place for early intervention; and have plans in place, in partnership with other relevant authorities, to take action to resolve banks in an orderly manner if they become non-viable.	
Description	In the EU the supervisory approach is outlined in the CRD and further detailed in the EBA regulations and guidelines, in particular the Guidelines on common procedures and methodologies for the supervisory review and evaluation process (SREP). It is applied in a proportionate manner to institutions depending on the nature, scale, and complexity of their activities. It is applied on a consolidated and solo basis, though the consolidated perspective generally receives most emphasis. In the SSM the SREP assesses an institution's viability at a 12-month horizon, in the medium term (3 to 5 years), and over the cycle, relying on a range of backward and forward-looking, quantitative and qualitative information, such as e.g., the outcome of stress tests. The SREP on Finnish LSIs is largely consistent with the EBA guidelines and gradually converging to the SSM approach. By performing the SREP assessment simultaneously for all the institutions under its direct supervision, the ECB is in a favorable position to identify common trends likely to affect all or part of the institutions under its responsibility. Horizontal analysis is also an integral part of the SSM SREP methodology. The FIN-FSA has its own expert focusing on the macro-economic environment and its effects on the banking sector, but relies extensively also on the macroeconomic expertise of the bank of Finland. The crisis management framework of the SSM covers a number of phases ranging from preparatory activities in the ongoing supervision of SIs to involvement in decisions on their resolution. However, during the resolution process, the main decision-makers are the resolution authorities: i.e., the Single Resolution Board (SRB) and the national resolution authorities (NRAs). Within this context, the SSM plays an advisory role and cooperates with NRAs/SRB on any necessary follow-up actions. In Finland the NRA is the Finnish Financial Stability Authority (FFSA). The methodologies for the supervision of the SIs are detailed in the ECB supervisory manual. They rest on a high degree of standardization and formalism (e.g., in the checklists that inspectors are required to use). While a certain degree of standardization is essential to establish a common language in such a new, vast, and multicultural organization, there is the risk of a drift towards an excess of compliance-

	based techniques and of a distraction of energy, time and resources from more risk-focused tasks.
Principle 9: Supervisory techniques and tools	
The supervisor uses an appropriate range of techniques and tools to implement the supervisory approach and deploys supervisory resources on a proportionate basis, taking into account the risk profile and systemic importance of banks.	
Description	In the SSM the appropriate mix between on-site and off-site supervision for a given SI results from the supervisory examination program (SEP). Based on the current supervisory priorities and on the categorization of banks in terms of their systemic footprint (six 'clusters' that break down the bank population in terms of size and complexity) and SREP scores (on a 1–4 scale), a SEP is decided for each bank. The SEP identifies, for each bank, according to its footprint (cluster) and risk profile (SREP score), the minimum engagement levels, core activities to be performed risk by risk. The FIN-FSA has a bi-annual planning process for on-site inspections and an annual planning process for off-site supervision. These plans reflect supervisory findings identified during supervisory activities.
Principle 11: Corrective and sanctioning powers of supervisors	
The supervisor acts at an early stage to address unsafe and unsound practices or activities that could pose risks to banks or to the banking system. The supervisor has at its disposal an adequate range of supervisory tools to bring about timely corrective actions. This includes the ability to revoke the banking license or to recommend its revocation.	
Description	According to the SSM Supervisory Manual, the ECB may identify the need for immediate supervisory measures to counteract negative developments at a SI during the exercise of its supervisory tasks, through on-going or on-site supervisory activities. The SSM framework for enforcement and sanctioning is based on a combination of powers assigned either to the ECB (as the power to withdraw an authorization) or the National Competent Authorities (NCAs), with the latter not being fully harmonized. Where the ECB lacks the powers to directly impose and enforcement measure or a sanction on a bank, it can request or instruct the NCAs to act, based on the powers available to them. This complex arrangement has not been put to the test so far in Finland. The ECB has initiated the collection of information on the powers available in each jurisdiction, with the aim of creating and maintaining a regulatory database; however, this project is ongoing. For LSIs, when supervisory concerns arise, the FSA engages the bank's management or, where appropriate, the bank's Board, informally or formally. All formal decisions or

	measures are taken by either the DG or the board of the FIN-FSA. Formal administrative actions are, for example, conditional fines, restrictions of the authorized business activity or management activities, appointment of an external attorney to supervise the activities of an authorized supervised entity, prohibition of the execution of a decision or revocation of the execution of the decision.
Principle 16: Capital adequacy	
The supervisor sets prudent and appropriate capital adequacy requirements for banks that reflect the risks undertaken by, and presented by, a bank in the context of the markets and macroeconomic conditions in which it operates. The supervisor defines the components of capital, bearing in mind their ability to absorb losses. At least for internationally active banks, capital requirements are not less than the applicable Basel standards.	
Description	The CRD and the Capital Requirements Regulation (CRR) implement the Basel capital standards in the EU and are complemented by EBA Regulatory Technical Standards (RTS) on Own Funds. They apply to all banks in the EU, irrespective of their internationally active nature. The compliance of the EU legislation with the Basel capital framework has been assessed by the Basel Committee in 2014 via it Regulatory Consistency Assessment Programme (RCAP). The assessment has found the implementation of the Basel framework in the EU Materially Non-Compliant; in particular, the EU framework has been found Compliant in terms of scope of application, transitional arrangements, capital buffers, internal models approach for market risk, operational risk, supervisory review process and disclosure requirements; Largely Compliant for definition of capital, standardized approach for credit risk, securitization framework, standardized approach for market risk; Materially Non-Compliant for the IRB approach for credit risk; Non-Compliant for the counterparty credit risk framework. Some of the deviations from the Basle standards depend on whether certain 'national discretions' contained in the CRD/CRR have been exercised; the ECB, in order to reduce the heterogeneity in the application of the prudential rules across the SSM, has initiated a process aimed at, first, performing a stock-take of the available discretions; then, collecting information on how these have been exercised in each jurisdiction and; finally, identifying those discretions that could be exercised directly by the ECB, thus enhancing the harmonization of the 'game rules' across the SSM. One such national discretion grants member states the option to allow banking groups that are part of a financial conglomerate the possibility not to deduct their participation in insurance companies, without having to demonstrate that this does not result in a lower level of calculated capital (as required by Basel). Finland has exercised this option and granted the waiver to a bank.

Principle 17: Credit risk	
The supervisor determines that banks have an adequate credit risk management process that takes into account their risk appetite, risk profile and market and macroeconomic conditions. This includes prudent policies and processes to identify, measure, evaluate, monitor, report and control or mitigate credit risk[30] (including counterparty credit risk)[31] on a timely basis. The full credit lifecycle is covered including credit underwriting, credit evaluation, and the ongoing management of the bank's loan and investment portfolios.	
Description	The CRD established certain requirements on banks' credit risk management. The EBA guidelines set the supervisor's expectations with respect to a bank internal credit risk processes. The ECB supervisory manual further complements the framework for supervision of credit risk by providing a series of investigative suggestions for the on-site inspections, covering the whole lifecycle of the lending activity, from granting loans to foreclosing collateral. Credit risk represents one of the sub-elements of the Capital element in the RAS. In Finland banks have to comply with FIN-FSA Standard 4.4a - Management of credit risk, which includes provisions on credit risk strategy and credit risk management procedures. There is no requirement in the law/regulation or in the supervisory methodology for a bank's Board or senior management to approve credit risk exposures exceeding a certain amount or percentage of a bank's capital or especially risky or otherwise not in line with the mainstream of the bank's activities (EC 6 of this principle).
Principle 18: Problem assets, provisions and reserves	
The supervisor determines that banks have adequate policies and processes for the early identification and management of problem assets, and the maintenance of adequate provisions and reserves.[32]	
Description	The EBA Guidelines ask supervisors to assess whether the bank has a sound, clearly formulated and documented credit risk strategy, approved by the management body; whether the bank has an appropriate organizational framework to enable effective credit risk management, measurement and control; and whether the bank has appropriate policies for the identification, management, measurement and control of credit risk. Similar requirements are contained in the FIN-FSA Standard 4.4a – Management of credit risk.

[30] Credit risk may result from the following: on-balance sheet and off-balance sheet exposures, including loans and advances, investments, inter-bank lending, derivative transactions, securities financing transactions and trading activities.

[31] Counterparty credit risk includes credit risk exposures arising from OTC derivative and other financial instruments.

[32] Reserves for the purposes of this Principle are "below the line" non-distributable appropriations of profit required by a supervisor in addition to provisions ("above the line" charges to profit).

	The EBA guidelines also ask supervisors to assess the overall credit quality at portfolio level and the different quality grades within the exposure categories of "performing," "nonperforming," and "forborne" to determine the institution's overall credit risk. Supervisors are not strictly required, but clearly recommended to use the EBA definitions of "non-performing" and "forborne" exposures (as used during the 2014 Asset Quality Review). In recent inspections conducted to verify the correct classification of exposures at some Finnish banks, the non-statistical nature of the samples of loan files analyzed on site prevented the use of extrapolation techniques, which would have allowed to calculate a level towards which the supervisor would expect the NPL ratios or forborne loan ratios to converge. The lack of granular data on household loans in Finland limits the possibility for the supervisor to closely monitor the evolution of certain phenomena (like the recent explosion of renegotiated loans). The limits in how the supervisory powers set forth in the CRD have been implemented in Finland (see BCP 1) prevent the FIN-FSA from imposing an adjustment to provisioning for prudential purposes.
Principle 22: Market risk	
The supervisor determines that banks have an adequate market risk management process that takes into account their risk appetite, risk profile, and market and macroeconomic conditions and the risk of a significant deterioration in market liquidity. This includes prudent policies and processes to identify, measure, evaluate, monitor, report and control or mitigate market risks on a timely basis.	
Description	The CRD requires competent authorities to ensure that policies and processes for the identification, measurement and management of all material sources and effects of market risks are implemented and that the internal capital is adequate for material market risks that are not subject to an own funds requirement. The EBA SREP guidelines specify elements of market risk management to be assessed by supervisors in SREP, which cover, among others: market risk strategies and appetites; organizational frameworks; policies and procedures; risk identification, measurement, monitoring and reporting; and, internal control framework. The ECB supervisory manual provides guidance / questions aimed at verifying the adequacy and soundness of the market risk management process of the institutions, taking into account the relevance of their market activity. The questions are spread over four dimensions: governance, risk appetite, risk management and internal controls, and internal audit. Market risk represents one of the sub-elements of the Capital element in the RAS.

	In Finland LSIs must meet the requirements of the standard on Management of market risk (4.4c), which comprise core principles for market risk management and control as well as provisions on the establishment and maintenance of these functions. Currently, only two LSI have trading books; currency risks in the banking book are also minor for LSIs.
Principle 23: Interest rate risk in the banking book	
The supervisor determines that banks have adequate systems to identify, measure, evaluate, monitor, report and control or mitigate interest rate risk[33] in the banking book on a timely basis. These systems take into account the bank's risk appetite, risk profile and market and macroeconomic conditions.	
Description	The CRD specifies the duties for the management body, to approve and periodically review the strategies and policies for taking up, managing, monitoring and mitigating risks; and addresses the need for banks to implement systems to identify, evaluate and manage the risk arising from potential changes in interest rates that affect non-trading activities. EBA Guidelines on the management of IRRBB provide guidance for methodology and measurements assumptions related to interest rate risk; stress testing and scenario requirements; governance arrangements as well as mitigation through the internal capital to IRRBB. They set the requirement that a bank's strategy, policies and processes be appropriately adjusted with the bank's changing risk profile and market developments and that the bank performs a regular review and independent validation of models used for interest rate risk management. The EBA SREP guidelines set out elements that supervisors should cover when assessing the management of interest rate risk from non-trading activities, including: interest rate risk strategies and appetites; organizational frameworks; policies and procedures; risk identification, measurement, monitoring and reporting; and, internal control framework. The assessment of IRRBB is also covered in the ECB supervisory manual and represents one of the sub-elements of Capital element in the RAS. In Finland LSIs are required to comply with the EBA Guidelines on the management of interest rate risk arising from non-trading activities.
Principle 24: Liquidity risk	
The supervisor sets prudent and appropriate liquidity requirements (which can include either quantitative or qualitative requirements or both) for banks that reflect the liquidity needs of the bank. The supervisor determines that banks have a strategy that enables prudent management of liquidity	

[33] Wherever "interest rate risk" is used in this Principle the term refers to interest rate risk in the banking book. Interest rate risk in the trading book is covered under Principle 22.

risk and compliance with liquidity requirements. The strategy takes into account the bank's risk profile as well as market and macroeconomic conditions and includes prudent policies and processes, consistent with the bank's risk appetite, to identify, measure, evaluate, monitor, report and control or mitigate liquidity risk over an appropriate set of time horizons. At least for internationally active banks, liquidity requirements are not lower than the applicable Basel standards.	
Description	The CRR introduced the Liquidity Coverage Ratio (LCR) in the EU; it is in force since October 2015. The commission delegated regulation (EU) 2015/61 supplements the CRR with regard to the LCR and provides details. The requirement follows the LCR set by the BCBS broadly, but with a number of divergences, which mostly are less conservative than the BCBS and as a result improve the ratios; one of these divergences is particularly relevant for Finnish banks: particularly generous eligibility criteria for covered bonds in the Highly Liquid Assets Buffer for the LCR. This represents a strong incentive for banks to stockpile liquidity in this form: for Finnish banks, covered bonds average around 30 percent of their liquid assets, representing a potential vulnerability. While covered bonds are generally a very solid and liquid form of investment, excessive concentration on a single type of product and on a restricted range of issuers (mostly from the Nordic area), in certain cases on a single issuer (even above 95 percent), increases the banks' exposure to extreme – but not implausible –events. As this form of investment is very common in the Nordic area, this translates into a high level of covered bonds cross-holdings among banks, which could become a particular source of contagion should a major correction in house prices materialize in the region and undermine market confidence in the otherwise solid covered bond market segment. The SSM methodology requires supervisors to verify that banks establish, and regularly review, funding strategies and policies and processes for the ongoing measurement and monitoring of funding requirements and the effective management of funding risk. The ECB Supervisory manual assesses the credit's institution strategy to ensure compliance with liquidity requirements in a comprehensive manner. It requires examiners to verify that the liquidity risk strategy is appropriately defined and communicated; established, approved and updated by management board; properly documented, effectively implemented and communicated to relevant staff; integrated within a bank's overall risk appetite framework. The FIN-FSA standard 'Management of liquidity risk' (4.4d) includes recommendations, application guidelines and examples, which are implemented in banking supervision based on proportionality principle. The standard includes requirements on liquidity strategy, liquidity risk management, control and procedures, liquidity buffer, stress testing and scenarios, contingency funding plan, and disclosure of information.