FINANCIAL STABILITY COUNCIL

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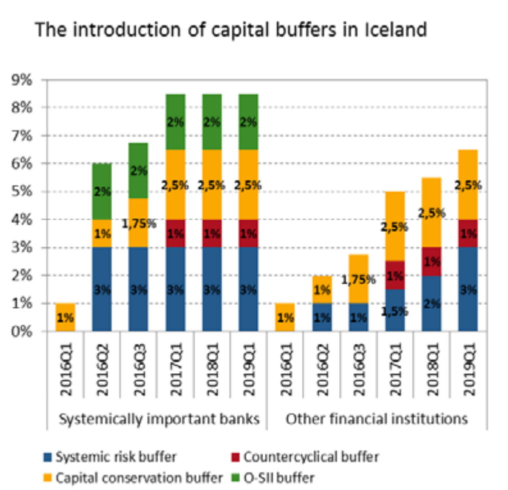
Introduction

According to Article 84(d) of the Act on Financial Undertakings, no. 161/2002, the Financial Supervisory Authority is authorised, upon prior receipt of recommendations from the Financial Stability Council, to impose capital buffer requirements on financial institutions. Capital buffers are intended to counter systemic risk in the financial system, enhance credit institutions' resilience against loan losses, and mitigate the impact of financial cycles on the real economy. Capital buffers are imposed on commercial banks, savings banks, and credit institutions.

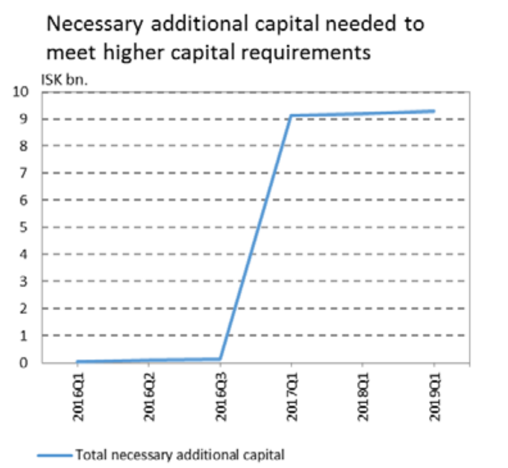
Necessary capital increase and adjustment period for higher requirements

In all likelihood, a decision on the value of the capital buffers will, on the whole, require only a small increase in financial system capital from the current level, as the Financial Supervisory Authority has recommended, ever since the 2014 appraisal and assessment was carried out, that certain deposit-taking institutions assume that capital buffers would be imposed on them.[1] The Financial Stability Council's recommendations assume that an adaptation period will be granted so as to allow institutions to adjust to the increased capital requirements. The capital conservation buffer is increased in increments. By law, it is subject to a maximum of 1% until 1 June 2016 and 1.75% from then until 1 January 2017. From then onwards, it shall be 2.5%. The Financial Stability Council recommends that the Financial Supervisory Authority impose a 2% buffer for systemically important institutions (O-SII buffer) effective 1 April 2016 and that the countercyclical capital buffer of 1% be binding in the first quarter of 2017. The Council also recommends to the Financial Supervisory Authority that the systemic risk buffer be set at 3% for the three large commercial banks as of 1 April 2016 and that it be increased incrementally for other deposit-taking institutions. It shall be set at 1% from 1 April 2016 until 1 January 2017, whereupon it will rise to 1.5%. On 1 January 2018 it will rise to 2%, and on 1 January 2019 it will rise to 3%.

[1] It is assumed here that, together with such a requirement, the Financial Supervisory Authority will set requirements under pillar 2, in line with its regularly conducted supervisory review and evaluation process (SREP).



The graph shows the introduction of capital buffers according to the recommendations made by the financial stability council in Iceland.
Source: The Central bank of Iceland



Total necessary additional capital that Icelandic financial institutions will need, in order to fulfill higher capital requirements following the introduction of capital buffers.
Sources: The Central bank of Iceland, The Financial Supervisory Authority of Iceland

The left-hand chart above illustrates the implementation process for the capital buffers on the large commercial banks, on the one hand, and smaller deposit-taking institutions, on the other. The right-hand chart shows the capital increase that the financial system as a whole will need in order to satisfy increased capital adequacy requirements based on the capital position as of end-Q3. Based on the current capital position of the financial system, the necessary capital increase will be about 9 b.kr. before the end of Q1/2017, or 1.5% of deposit-taking institutions' current total capital.

Introduction of capital buffers in other countries

Among Iceland's neighbouring countries, implementation of capital buffers has differed to some extent, and each country has proceeded in accordance with prevailing internal conditions. Table 1 lists the capital buffers in effect or announced in each of the Nordic and Baltic countries. Denmark has implemented a systemic risk buffer based on the risk stemming from systemically important financial institutions. The capital buffer therefore applies only to banks that have been classified as systemically important in Denmark.[2]

Finland has only imposed an O-SII capital buffer, while Sweden has imposed a systemic risk buffer, an O-SII buffer and a countercyclical capital buffer.[3] There, as in Denmark, the systemic risk buffer is used as to address risk stemming from systemically important financial institutions, and it applies only to the four largest banks in the country. In addition, the Swedish Financial Supervisory Authority has imposed a 2% additional requirement under Pillar 2 on the four largest banks. These additional requirements are also intended to address the systemic risk related to the systemic importance of these banks. Furthermore, the Swedish Financial Supervisory Authority has imposed a 1% countercyclical capital buffer and announced that it will rise to 1.5% in June 2016. The increase in the buffer is based, among other things, on increased credit growth and high household debt levels. Estonia has

[2] The implementation of a systemic risk buffer on the basis of systemic importance is permissible under the CRD, and various countries have elected to use the systemic risk buffer as a substitute for the capital buffer for other systemically important institutions (O-SII buffer), as the former is more flexible. Unlike the O-SII buffer, there are no restrictions on the size of the systemic risk buffer; furthermore, the O-SII buffer could not be implemented before 1 January 2016, while the systemic risk buffer could be applied earlier.

[3] In Sweden, systemically important financial institutions will only be required to fulfil the requirements of the systemic risk buffer and not the O-SII buffer because, according to the CRD, it is prohibited to combine the O-SII buffer and the systemic risk buffer if the systemic risk buffer is intended to apply to all of a financial institution's exposures.

implemented a systemic risk buffer only, based on a rationale similar to that used in Iceland: that there is systemic risk related to the structure, small size, and openness of the economy. In Estonia, the systemic risk buffer is applied to all banks and all exposures. Norway has either implemented or announced the upcoming implementation of a countercyclical capital buffer, a systemic risk buffer, and an O-SII capital buffer. However, the intention there is to combine the systemic risk buffer and the O-SII buffer even though the systemic risk buffer extends to financial institutions' total exposures, which is not in line with Article 133 of EU Directive no. 2013/36/EU, the Capital Requirements Directive (CRD IV). Furthermore, it has been announced that the countercyclical capital buffer in Norway will rise from 1% to 1.5% in June 2016, owing to growing financial market imbalances, increased household debt, and rising real estate prices.

Table 1. Capital buffers in the Nordic and Baltic countries

Country	Systemic risk buffer %	Grounds for systemic risk buffer	Coverage of systemic risk buffer	O-SII buffer %	Interaction	Countercyclical capital buffer %
Denmark	1-3%	Systemic risk related to systemically important financial institutions	Six systemically important banks. All exposures.	0%	Systemic risk buffer only	0%
Estonia	2%	Systemic risk related to small size and openness of economy. Significant concentration in the banking market.	All banks and all exposures.	0%	Systemic risk buffer only	0%
Finland	0%	-	-	0.5-2%	Capital buffer for systemic importance only	0%
Norway	2-3%	Concentration of exposures	All banks and <u>all exposures</u>	1-2%	Both apply, in contradiction to CRD Article 133	1.5%
Sweden	3%	Systemic risk related to systemically important financial institutions	Four largest; all exposures	2%	Systemic risk buffer applies	1.5%