FINANCIAL STABILITY COUNCIL

Ministry of Finance and Economic Affairs, Arnarhvoli, 150 Reykjavik
Tel: (+354) 545 9200
fjarmalastodugleikarad.is

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Recommendation concerning the capital buffer for other systemically important financial institutions: rationale

Introduction

Systemically important regulated entities are those that, due to their size and the nature of their activities, could have a significant negative impact on financial stability and the real economy if they experience difficulties. For this reason and because systemically important regulated entities are usually important in terms of financial markets operations, public access to payment services, and individuals' access to their own funds, the public safety net for such entities is tighter than for others and both direct and indirect guarantees of their obligations are more extensive. This amplifies the moral hazard involved, as these entities take on more risk than is optimal for the financial system at large. Therefore a regulatory framework, in particular increased capital requirements and more active monitoring, is needed to counteract this tendency.

In order to address this, authorisations to impose additional capital requirements on systemically important financial institutions have been passed into law.[1] Such a requirement may range up to 2% of the institution's risk weighted assets. The additional capital requirement will enhance the resilience of the financial institutions concerned, reduce the likelihood of their failing and thereby mitigate the expected negative impact on the financial system and the real economy. If a regulated entity is classified as systemically important, this classification affects the frequency and scope of the monitoring carried out by the Financial Supervisory Authority and the Central Bank. Systemically important financial institutions are placed in category 1 according to the European Banking Authority's (EBA) Guidelines on common procedures and methodologies for the supervisory review and evaluation process (SREP), and supervisory bodies are to consider this in their regular monitoring activities. [2]

[1] According to Article 84(c) of the Act on Financial Undertakings, no. 161/2002.
[2] European Banking Authority (2014). Guidelines on common procedures and methodologies for the supervisory review and evaluation process (SREP), (EBA/GL/2014/13).

Framework for systemically important supervised entities

The EBA's methodology for assessing the systemic importance of financial institutions, set out in the guidelines issued on 16 December 2014,[3] is consistent with the requirements of the CRD-IV/CRR legislation implemented in Iceland last summer with amendments to the Act on Financial Undertakings, no. 161/2002. The methodology is based on the international framework designed by the Basel Committee to identify systemically important domestic banks.[4] In Iceland, the methodology behind the classification of systemically important financial institutions according to the EBA guidelines has been applied to all regulated entities for the purpose of determining which institutions are considered systemically important regulated entities. In addition to the three largest commercial banks, the Housing Financing Fund is considered systemically important, as the Financial Stability Council has already confirmed.[5]

Table 1: Assessment of systemic importance of supervised entities according to EBA method

	Category	Indicators	Lands-bankinn	Arion Bank	Íslands-banki	Housing Financing Fund	Others
Step 1 :	1. Size	Total assets	2815	2393	2336	2175	347
	2. Importance	Value of domestic payment transactions Domestic private sector deposits Lending to domestic private sector	2886	2447	3194	912	560
	3. Complexity and cross-border operations	Value of OTC derivatives Cross-border liabilities Cross-border assets	3257	3417	3313	0	12
	4. Interconnectedness	Interbank liabilities Interbank assets Debt securities outstanding	2476	3111	1961	2283	169
	Total weighted points after step 1:		**2858**	**2842**	**2701**	**1343**	**272**
Step 2:	Importance	FX market turnover	3518	3115	3366	0	0
	Total weighted points after step 2:		**2898**	**2884**	**2712**	**1286**	**237**

Four categories of indicators are used to identify systemically important supervised entities. Each category contains core indicators of systemic importance, and the entities being evaluated are assigned points reflecting their share and activities in the financial market in each category. Each entity's total score is calculated as the weighted average of the points it received for each indicator in each category. Each category carries equal weight, as does each indicator within each category. According to the EBA

[3] European Banking Authority (2014). Guidelines: On the criteria to determine the conditions of application of Article 131(3) of Directive 2013/36/EU (CRD) in relation to the assessment of other systemically important institutions (O-SIIs), (EBA/GL/2014/10).

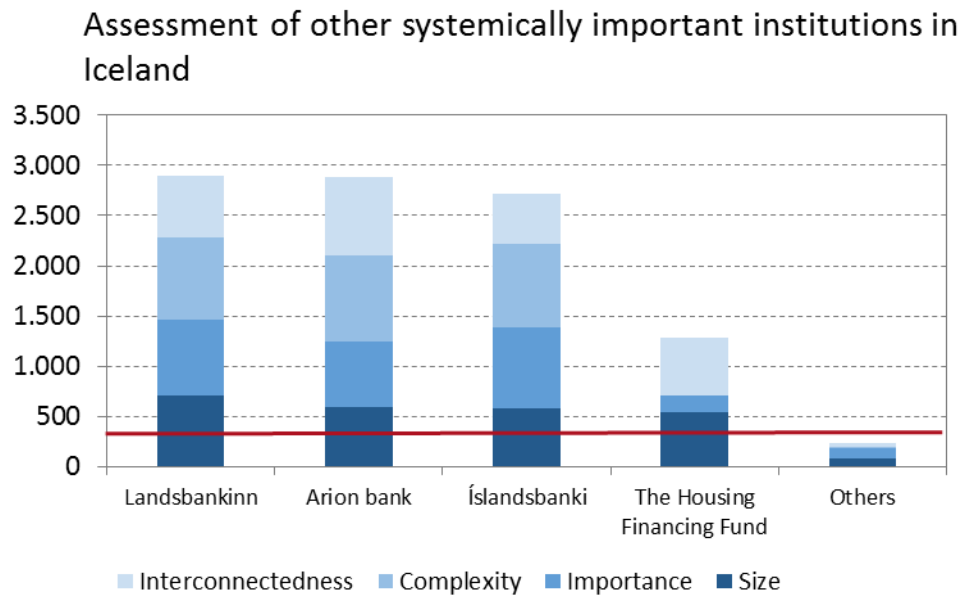
[4] Basel Committee on Banking Supervision (2012). A framework for dealing with domestic systemically important banks.

[5] https://www.fjarmalaraduneyti.is/frettir/nr/19269

methodology, it is recommended that those entities with a total score of over 350 points be classified as systemically important financial institutions. In Iceland, this assessment by the EBA is applied to all regulated entities. The assessment is carried out in two stages: in step 1, the aforementioned core indicators recommended in the EBA guidelines are used, and in step 2 supervisory bodies are allowed to add further indicators, which can also be found in the guidelines. Table 1 gives a summary of the indicators that were used in the assessment, together with the results of the assessment based on year-2014 annual accounts.

It has been decided to consider the entities' share in foreign exchange market activity in step 2 of the assessment. The three large banks split foreign exchange market activity more or less equally among themselves. This time, no other indicators were examined in step 2 of the assessment. Based on the results of the assessment, four regulated entities should be classified as systemically important in Iceland: Landsbankinn with 2,898 points, Arion Bank with 2,884 points, Íslandsbanki with 2,712 points, and the Housing Financing Fund with 1,286 points – all of them well above the 350-point threshold recommended by the EBA.

According to the Act on the Financial Stability Council, the Council is to confirm the classification of systemically important regulated entities and, according to the Act on Financial Undertakings, it shall submit recommendations concerning the capital buffer for systemically important financial institutions to the Financial Supervisory Authority. The regulated entities' annual accounts for 2014 were used to carry out the aforementioned assessment, and from now on, assessments of systemic importance will be conducted annually based on annual accounts. The next revision of the assessment will be at the Financial Stability Council's April 2016 meeting.



The graph shows the results from step 2 of the assessment of the systemic importance of Icelandic financial institutions. The red line shows the 350 point limit suggested by EBA.
Sources: The Financial Supervisory Authority.

Conclusion

According to the analysis of the Systemic Risk Committee, which works for the Financial Stability Council, four regulated entities are considered systemically important in Iceland: Landsbankinn hf., Arion banki hf., Íslandsbanki hf., and the Housing Financing Fund. The Financial Stability Council has confirmed the systemic importance of these four entities, which will be monitored in accordance with this assessment.

The Financial Stability Council recommends that the Financial Supervisory Authority impose capital buffers for other systemically important institutions on Landsbankinn hf., Arion Bank hf., and Íslandsbanki hf., effective 1 April 2016. In view of the large margin by which these entities' scores exceed the EBA's 350-point benchmark, the Council recommends that the capital buffer be set at 2%, the maximum permissible by law. The Council also recommends to the Financial Supervisory Authority that the capital buffer be maintained at the group level and that it extend to all of the commercial banks' exposures. The requirement will apply only to the three commercial banks, as the provisions on capital buffers in the Act on Financial Undertakings do not apply to the Housing Financing Fund.