Regulatory landscape in the Nordics

This blog provides an overview of the Nordic regulatory landscape related to Basel regulations, and changes required as part of Basel 3.1. We identify key differences between country-specific regulations that will impact the requirements that bank management teams have to meet, and how these are addressed in practice.

This is the fifth publication in the "Basel 3.1 – Nordics ready!" blog series. The series covers various aspects of Basel 3.1 with a focus on considerations for Nordic banks, including minimum capital requirements, the regulatory landscape, strategic and operational considerations, and how to implement Basel 3.1. Here, we summarize some of the key differences in regulatory requirements across the Nordic countries and present how they could affect banks in these countries.

Key takeaways

- Essential for board and management teams to assess the readiness of Basel 3.1 implementation plans to address increasing regulatory standards, considering the potential impacts across the model development and approval cycle (e.g. data collection and management, internal challenge and governance, board involvement)
- The Nordic Financial Supervisory Authorities (FSAs) responsible for prudential regulation of banks in each Nordic country have made local interpretations of the Basel capital requirement regulations which creates impacts for banks operating in the Nordics.
- Nordic FSAs are increasing the level of scrutiny in the assessment of internal models as they seek to push up standards to ensure a level playing field within each country and with European banks.
- Regulatory harmonization through Basel 3.1 is designed to improve comparability of banks but local adoptions in the Nordics are expected to differ, to ensure that national macroprudential measures and priorities are met.

Our Basel blog series has noted how Basel 3.1 aims to improve the comparability of banks across jurisdictions and that the new rules are expected to impact the strategy and operations of the Nordic banks. The current Nordic regulatory landscape has key differences among the Nordic FSAs which Nordic banks need to understand in order to implement the new reforms and meet local regulatory expectations. The differences in interpretation of requirements related to credit risk, capital floors and minimum capital requirements plus capital buffers are discussed here.

The recent bank collapses, seen in the United States and Switzerland, add complexity as this may strengthen the argument that long-term financial sector competitiveness is best served by maintaining high regulatory standards consistent with international agreements. The implementation of Basel 3.1 and the finalization of Nordic FSA interpretations will be a crucial test.

Overview of the current regulatory landscape in the Nordics

The expectation is that Basel 3.1 will be implemented into European legislation this year, but customization for local adoption by Nordic FSAs remains in progress. However, local adoption is expected to be aligned with the EU timelines, consistent with the European Central Bank (ECB) and European Banking Authority (EBA).

As before, Nordic regulators are anticipated to continue to adapt European and global requirements for local priorities. The tables below provide an overview of the current national macroprudential measures in the Nordics. The extensive list of current differences highlights the need for management teams in the Nordic banks to remain active in the consultations with their local supervisors, throughout the implementation of Basel 3.1.

Table 1. Selected differences in the Nordic Regulatory landscape related to credit risk

Denmark	Norway	Iceland	Sweden	Finland
Maximum Loan-to-Value (LTV) for all buyers of 80%*	Maximum LTV ratio for installment loans is 85% and for home equity credit lines is 60%. LTV cap of 60% for secondary homes in Oslo	Maximum LTV for first-time buyers 85%. Maximum LTV for other buyers at 80%.	Maximum LTV for all buyers 85%	Maximum LTV is 85% (except for first time buyers)

* Please note that maximum LTV refers to retail mortgage exposure

In the Nordics, banks are heavily exposed to the mortgage market, therefore regulators have imposed credit risk mitigating limits on the maximum Loan to Value (LTV) allowed for a bank to take on when granting a loan. The maximum LTV´s are not directly linked to Basel 3.1, but the actual distribution of LTV among IRB banks will have an impact due to the new risk weights (RWs) for real estate exposures in Basel 3.1 as we discussed in the white paper, Basel 3 reforms – the impact on Nordic banks.

Table 2. Current capital floors and minimum capital requirements in the Nordics

Denmark	Norway	Iceland	Sweden	Finland
No RW floors	RW floor (until end 2022*) is: - 20% for residential real estate - 35% for commercia relate estate	No RW floors	RW floor is: - 25% for residential real estate (mortgages) - 35% commercial real estate - 25% for some corporate exposures secured by residential properties	No RW floors
Pillar 2 add-on for underestimation identified in backtesting of IRB credit risk parameters	PD and LGD floor of 0.2% and 20% respectively for mortgage loans	No specific requirements	No specific requirements	No specific requirements

* Agreement in place for max 2 years at a time. Current Norwegian FSA recommendation is to extend to 2025.

Currently, Sweden and Norway are the only countries in the Nordics with an RW floor on residential real estate (RRE) and commercial real estate (CRE) for IRB banks, as described in Table 2 above. In Sweden, these RW floors were implemented following an assessment made by the SFSA that the relatively high property prices and high debt ratios among the households constituted a systemic risk to financial stability. To mitigate this risk, a RW floor for IRB banks was implemented in August 2018 as they together hold a major part of the RRE and CRE market in Sweden. In Norway, floors are set on PD and LGD parameters to ensure that IRB banks and financial institutions maintain a minimum level of risk sensitivity in their calculations of Risk Weighted Assets (RWAs) and capital requirements. This is because, like in Sweden, household debt is higher than mainland Norway's GDP and has risen faster

than household income over time although credit growth has slowed down. The relatively high level of debt makes households vulnerable to increases in interest rates and/or loss of income, which may lead to reduced economic activity and increased unemployment. The uncertain inflation outlook adds to this vulnerability. The regulation has been in effect since December 31, 2020.

Sweden and Norway currently have RW floors for RRE and CRE loans applicable for banks with an IRB approval, but it is unclear how regulators will address them under Basel 3.1. The new output floor in Basel 3.1, will likely encompasses the risk captured by the RW floors in Norway and Sweden currently, suggesting their removal. This is also indicated by the Swedish regulator in their latest memorandum on the floors, where it is acknowledged that the outcome of the new Basel 3.1 standards might lead to changes in the current domestic risk floor regulation to account for the overall effects of new regulation.

Table 3. Current capital buffers in the Nordics

Denmark	Norway	Iceland	Sweden	Finland
Conservation buffer (CCoB) at 2.5%	Conservation buffer (CCoB) at 2.5%	Conservation buffer (CCoB) at 2.5%	Conservation buffer (CCoB) at 2.5%	Conservation buffer (CCoB) at 2.5%
Countercyclical buffer (CCyB) at 2.5%	Countercyclical buffer (CCyB) at 2.5%	Countercyclical buffer (CCyB) at 2%	Countercyclical buffer (CCyB) at 1%	Countercyclical buffer (CCyB) at 0%
Systemic Risk Buffer (SyRB) of between 0.5% and 3% for 7 O-SIIs depending on the level of systemic importance of each institution	Systemic Risk Buffer (SyRB) of 4.5% for domestic exposures. Banks not using the Advanced IRB Approach will be subject to a 3% SyRB on all exposures until the end of 2023.	Systemic Risk Buffer (SyRB) at 3%	Systemic Risk Buffer (SyRB) at 3%	Systemic Risk Buffer (SyRB) at 0% but will increase to 1% from 1 April 2024
Eight O-SIIs identified. Individual buffer requirements have been applied	Three O-SIIs identified. Individual buffer requirements have been applied	O-SII buffer at 2% (three institutions)	Four O-SIIs identified. Individual buffer requirements have been applied	Three O-SIIs identified. Individual buffer requirements have been applied

Regarding the different capital buffers**,** the Capital Conservation Buffer (CCoB) is set at a consistent level for all the Nordic countries. The Countercyclical Buffer (CCyB) is at similar levels in Denmark, Norway and Iceland, but both Sweden and Finland stand out as having a lower CCyB respectively. The Systemic Risk Buffer (SyRB) on the other hand is set at different levels among the Nordic countries which spans from 0% to 4.5%, where Norway currently has an SyRB of 4.5% for domestic exposures then Finland removed the SyRB requirements in 2020 to alleviate the effects of the Covid-19 pandemic. However, from 1 April 2024 a new SyRB of 1% will be applicable for all credit institutions in Finland. The differences in the various capital buffers stem from the assessments made by the respective Nordic FSA regarding the level of buffer required per country to ensure the banking market continues to function effectively in case of a financial crisis. However, it effectively creates potential competitive disadvantages for banks operating in a country with relatively high buffers, since they need to hold more capital which in turn will affect their return on capital negatively, all else equal.

Table 4. Liquidity coverage ratio (LCR) requirements in the Nordics

Denmark	Norway	Iceland	Sweden	Finland
LCR > 100% for all significant foreign currencies* excluding NOK and SEK	LCR > 100% for all significant foreign currencies. LCR > 50% for NOK for those who have EUR or USD as significant currencies*	LCR > 80% for EUR for credit institutions whose EUR-denominated liabilities equal 10% or more of their total liabilities. LCR > 50% for ISK	LCR > 100% in USD, EUR LCR > 75% for every other individual currency, including SEK	No specific LCR requirement

* A currency is significant if it amounts to at least five per cent of the bank's total liabilities in accordance with Article 415(2) (a) of the CRR.

In addition to the general requirement of a Liquidity Coverage Ratio (LCR) of minimum 100% pursuant to Article 142 of CRR, there exist different variations of currency specific requirements in all Nordic countries except for Finland. For example, in Denmark, the LCR currency requirement shall be met for all significant currencies excluding NOK, SEK and the reporting currency of the bank (typically DKK). In Sweden the 100% applies to USD and EUR while the requirement is 75% for all other individual currencies.

Regulatory landscape in the Nordics after Basel 3.1

The Basel 3.1 reforms seek to reduce variability in RWA calculations across different banks and jurisdictions. Our experience from working with banks and regulators is that harmonization between the European and Nordic regulators has continued to progress.

For example, the perception in the market has been that the Nordic FSAs and ECB have different standards when it comes to the depth of the assessment of internal models. This was exemplified by the targeted review of internal models (TRIM), launched by the ECB at the beginning of 2016 to assess whether the internal models complied with regulatory requirements, and whether their results were reliable and comparable. According to ECB 2021 TRIM report, this review resulted in over 8,500 findings from 65 European significant institutions (SIs), which are expected to result in an approximately 12% (€275 billion) increase in RWAs. No equivalent exercise with this level of scrutiny has been carried out in the Nordic region before. However, the nature of the findings provides a source of information for Nordic FSAs to set local standards and expectations regarding what "good enough" looks like.

Moreover, in 2018, the EBA noted in their opinion on the Swedish risk weight floor that the Swedish FSA (SFSA) should find a more long-term solution to the underlying issue of the low RWs for mortgage lending. The EBA highlighted that if the low RWs calculated by the Swedish banks' internal models do not adequately capture the credit loss risk, other methods should be applied to mitigate the systemic risk posed by the Swedish mortgage sector. The EBA welcomed the ongoing process to complete a bottom-up review and repair of IRB models in Sweden. Improvements to the existing IRB models in Swedish banks is identified as part of the long-term solution, noted by the EBA as being needed. The EBA suggested that the SFSA reviews the RW floor following the changes to the applicable regulatory framework (i.e., the sectoral SRB and the output floor discussed in this blog).

There are 20 IRB banking groups in the Nordics, where three are in Norway, nine in Sweden, six in Denmark and two in Finland, while banks in Iceland have permission to use the standardized approach only. As mentioned above, we see a trend towards a stricter assessment in the IRB application process among the Nordic FSAs. This is evident in the following memorandum (in Swedish) from the SFSA, stating that a relatively large proportion of the IRB applications submitted to comply with the new EBA guidelines have not fulfilled the requirements, and have therefore been withdrawn by the relevant banks. The review of the new models is a high priority area for the SFSA going forward. Complying with

the new guidelines on both definition of default and internal model methodology is strategically important for bank management teams. Banks anticipate they will get approval from supervisors in a timely manner. However, the additional scrutiny and the corresponding challenges to meet supervisory expectation may instead imply delays, additional capital add-ons or even worse, a withdrawal of the IRB approval. This is a strategic risk which Boards will want to mitigate and can be an accelerator for management teams to assess the need for better data collection and management, improved internal challenge and governance and better involvement of board and senior execs in the modelling process. Ultimately, now is the time to consider whether IRB remains the right choice for a bank, versus a less costly standardized approach, in light of Basel 3.1. The options to banks are discussed in more detail in our white paper To be or not to be IRB.

In conclusion, the implementation of Basel 3.1 will most likely lead to increased regulatory scrutiny and harmonization among the Nordic countries. However, Nordic FSAs responsible for implementing Basel 3.1 still have to provide guidance, which could increase or reduce the number of local differences between FSAs. This uncertainty, in addition to the continued increases in regulatory scrutiny will add to management and board level discussions regarding the benefits of using internal models and whether strategic choices previously made, remain in the best interest of banks.

Management teams preparing for the Basel 3.1 changes should use horizon scanning across the Nordic and European regulators to understand the evolution of the Basel 3.1 interpretations. This will be informed by targeted discussions with supervisors to understand the direction of travel, with structured sharing of insights to impacted functions (e.g. risk modelling, independent model validation, Credit Risk Control units, Finance) coordinated by regulatory affairs. Plans and actions will need to be determined which can maintain progress whilst adapt to the evolving regulations.