FINANSTILSYNET
THE FINANCIAL SUPERVISORY
AUTHORITY OF NORWAY

Guidance

# Finanstilsynet's practices for assessing risk and capital needs

The guidance applies to banks, financial holding companies, mortgage companies and finance companies

**20 December 2024**

# 1. Definitions, abbreviations and legal basis

## 1.1. Definitions and abbreviations

| | |
|---|---|
| SREP | *Supervisory Review and Evaluation Process*<br>The supervisory authorities' process for assessing institutions' overall risk level and capital needs, as well as supervisory measures. |
| ICAAP | *Internal Capital Adequacy Assessment Process*<br>The institution's own assessments of risk and capital needs |
| ILAAP | *Internal Liquidity Adequacy Assessment Process*<br>The institution's own assessments of risk and liquidity needs |
| P2R | *Pillar 2 requirement*<br>Pillar 2 requirement / institution-specific capital requirement |
| P2R-LR | *Pillar 2 requirement leverage ratio*<br>Institution-specific leverage ratio requirement |
| P2G | *Pillar 2 guidance*<br>Risk-weighted Pillar 2 guidance |
| P2G-LR | *Pillar 2 guidance leverage ratio* |
| CRD | Capital Requirements Directive, Directive 2013/36 |
| CRR | Capital Requirements Regulation, Regulation 575/2013 |
| LCR | *Liquidity Coverage Ratio*<br>Liquidity buffer |
| NSFR | *Net Stable Funding Ratio*<br>Stable long-term funding |
| IRB approach | *Internal Ratings-Based Approach* |
| EVE | *Economic Value of Equity* |
| NII | *Net Interest Income* |
| IRRBB | *Interest Rate Risk in the Banking Book* |
| CSRBB | *Credit Spread Risk in the Banking Book* |
| EBA | *European Banking Authority* |
| IMF | *International Monetary Fund* |

## 1.2. Legal basis

Institutions shall assess risk and the associated capital needs on a regular basis, cf. the Financial Institutions Act, section 13-6, subsections (1) to (3). The institution shall have own funds appropriate to the risk inherent in and the volume of the activities carried on by the institution and ensure prudent liquidity management, cf. the Financial Institutions Act, section 13-7 and part V of the CRR/CRD Regulations.

Capital needs shall be assessed at consolidated level and include all group entities, cf. the CRR/CRD Regulations, section 23. The names of all group entities must be stated in the ICAAP and ILAAP. The ICAAP and ILAAP shall show the distribution of risk and capital needs for the entire group and for each of the main entities in the group, cf. the CRR/CRD Regulations, section 23. In addition to group entities, the ICAAP shall also include an assessment of risk and capital needs related to ownership interests in affiliates and cooperating groups, cf. the Financial Institutions Act, section 17-13.

Finanstilsynet shall assess the institution's total risk and capital needs, cf. the Financial Institutions Act, section 14-6 subsection (2). If the overall risk assessment shows that the institution's risks are not covered by the general capital requirements (Pillar 1 requirements[1]), Finanstilsynet may set institution-specific capital requirements (Pillar 2 requirements) or business restrictions to ensure that that the institution's own funds are in accordance with its risk exposure, cf. the Financial Supervision Act, section 4, the Financial Institutions Act, section 13-6 subsection (7) and the CRR/CRD Regulations, section 46 first subsection.

Finanstilsynet may set an institution-specific capital requirement to cover risks that are not, or only partially, covered by the general Pillar 1 requirements, cf. CRR/CRD Regulations, section 46 first subsection (a). Finanstilsynet shall also set an institution-specific capital requirement for institutions that do not comply with regulations on assessment of risk and overall need for capital (ICAAP), governance and control, or large exposures, unless other supervisory measures are deemed sufficient, cf. first subsection (b). Furthermore, it follows from the first subsection (c) that Finanstilsynet may set Pillar 2 requirements if the institution's policies and procedures for adjustments in the valuation of positions or portfolios in the trading book under CRR Article 105 are insufficient. Finanstilsynet may set an institution-specific capital requirement if the institution's non-compliance with the requirements and conditions relating to the use of internal models would lead to an insufficient level of capital, cf. the first subsection (d). Finanstilsynet may set Pillar 2 requirements if the institution has repeatedly failed to establish or maintain a sufficient margin to the capital requirements, as set out in the CRR/CRD Regulations, section 47 second subsection, cf. section 46 first subsection (e). Furthermore, it follows from the CRR/CRD Regulations, section 46 first subsection (f) that Finanstilsynet may set an institution-specific capital requirement if 'other institution-specific situations' are deemed to raise material supervisory concern.

Capital used to meet the institution-specific capital requirement shall consist of a minimum of 56.25 per cent CET1 capital and 75 per cent Tier 1 capital, which corresponds to the capital composition requirement under Pillar 1. Finanstilsynet may set stricter requirements for the composition of capital for individual institutions when this is necessary in order to maintain the institution's capital adequacy, cf. the CRR/CRD Regulations, section 46 fifth subsection.

Automatic restrictions on overall disbursement of dividends and interest on Tier 2 capital and performance-based remuneration are triggered by failure to comply with the minimum Pillar 1 and Pillar 2 requirements and the buffer requirements, cf. the Financial Institutions Act, section 14-3 and the CRR/CRD Regulations, section 10.

Finanstilsynet's SREP framework, as described in this guidance, is based on the EBA's SREP guidelines (EBA/GL/2022/03), cf. Article 97 of the CRD.

[1]Includes buffer requirements, cf. the Financial Institutions Act, section 14-3

This guidance will be updated as new capital requirements rules (CRR 3) enter into force. Finanstilsynet expects the institutions to report on the impact of new capital requirements in ICAAP/ILAAP as part of their assessment of capital needs in a forward-looking perspective.

## 1.3. Submission of the ICAAP/ILAAP

All institutions are obliged, regardless of the frequency of the SREP assessments, to prepare an ICAAP and an ILAAP at least annually. The ICAAP and ILAAP shall be integrated into operations, be carried out at the highest level of consolidation and be approved by the institution's board of directors.

Finanstilsynet uses 31 December as a reference date for assessing risk and capital needs. Finanstilsynet will also take account of the institution's ICAAP and ILAAP when there is another reference date than 31 December. However, a higher level of discretion is required in cases where there are significant discrepancies between the institution's own assessment and Finanstilsynet's assessment.

The ICAAP and ILAAP shall be sent to Finanstilsynet, generally by 30 April, as an attachment to Altinn form KRT 1172. The ICAAP and ILAAP must be in a machine-readable/searchable format.

# 2. Introduction

This guidance and appendices describe Finanstilsynet's process for assessing institutions' overall risk level and need for capital (SREP), and supervisory measures, as well as Finanstilsynet's methodology for assessing capital needs under Pillar 2. The guidance is based on and must be viewed in the context of the EBA's SREP guidelines and the determination of capital needs under Pillar 2. This guidance replaces Finanstilsynet's Circular 3/2022.

Chapter 3 provides an overview of the various sub-processes included in the SREP and how these are interconnected. Chapter 4 describes the division of institutions into categories that determines the frequency and scope of Finanstilsynet's SREP and dialogue with individual institutions. Chapter 5 describes Finanstilsynet's ongoing monitoring of institutions' risk level and risk developments. Chapter 6 provides an overview of important assessment criteria included in Finanstilsynet's analysis of institutions' business model, as well as business and strategic risk. Chapter 7 provides an overview of the key criteria emphasised by Finanstilsynet when assessing institutions' internal governance. Chapter 8 describes Finanstilsynet's assessment of institutions' various risk areas. The overall risk assessment is discussed in chapter 9. Chapter 10 covers the assessment of institutions' capital needs and describes the various methods used as a tool to support Finanstilsynet's assessment of institutions' total and institution-specific capital needs (Pillar 2). The methods are described in detail in appendices 2-4. Chapter 11 addresses other measures under Pillar 2, including LCR requirements in foreign currency. Chapter 12 provides an overview of relevant supervisory measures and tools, including orders for corrective measures. Chapter 13 describes SREP for cross-border groups. The Pillar 2 guidance (P2G) is described in Appendix 5.

In addition to the methods and assessment criteria discussed in this guidance, Finanstilsynet takes account of the institutions' own assessments of risk, capital needs and liquidity needs (ICAAP and ILAAP). Requirements relating to institutions' ICAAP and ILAAP are discussed in further detail in Appendix 1.

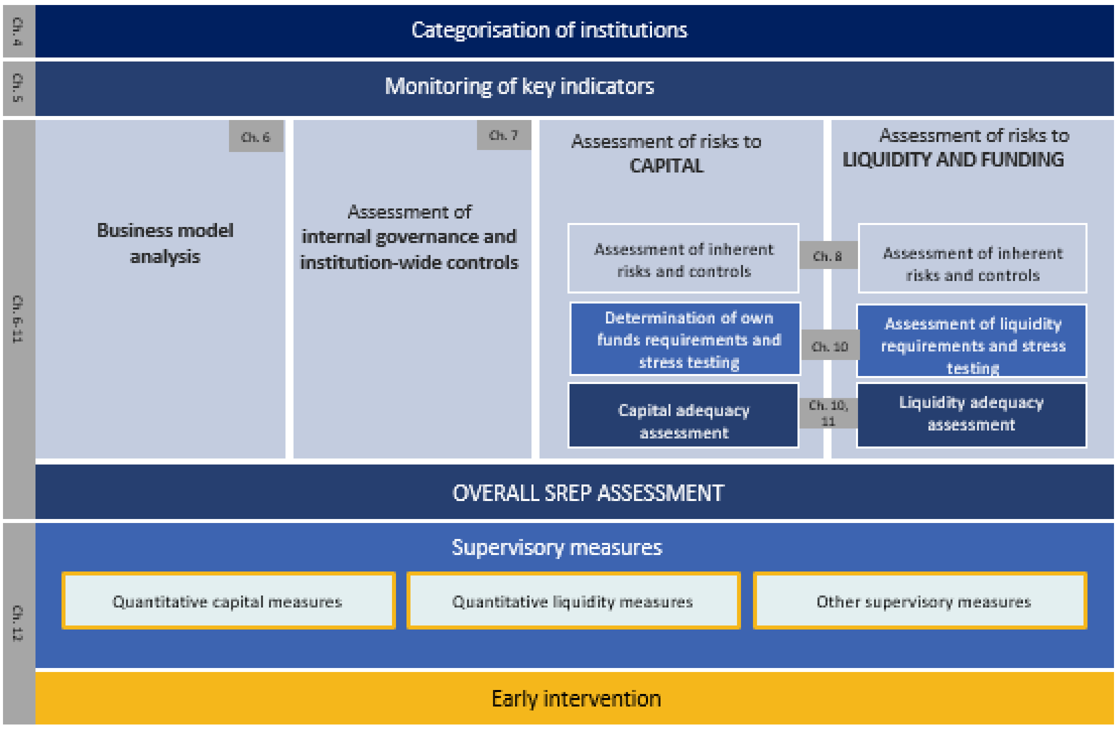
# 3. The SREP framework in brief

## 3.1. Processes and assessments included in the SREP

- Dividing institutions into categories for SREP purposes
- Monitoring of key performance indicators
- Assessment of business model, including business and strategic risk
- Assessment of overall systems for internal governance
- Assessment of risk and capital needs and the institutions' capitalisation
- Assessment of risk related to the institution's liquidity and funding, as well as the institution's liquidity and funding needs
- Assessment of supervisory measures, including institution-specific capital requirements (Pillar 2)

The chart below summarises the various processes and assessments included in the SREP, with references to the chapters in which these are discussed.

**Chart 1: Overview of the various elements included in the SREP**



## 3.2. Contradiction and right to appeal

Finanstilsynet summarises its assessment of the individual institution's risk and capital needs, as well as supervisory measures, including institution-specific capital requirements, in a letter sent to the institution's board of directors. The board is given the opportunity to comment on Finanstilsynet's assessment within a set deadline. After Finanstilsynet has received the board's comments, a final assessment is made of the institution's risk and capital needs, as well as supervisory measures, including institution-specific capital requirements.

Finanstilsynet prepares a letter to the institution, summarising and explaining its final SREP assessment.[2] Finanstilsynet may, through its SREP feedback or in some other way, express its expectations concerning improvements or issue orders for improvements.[3]

In its letter, Finanstilsynet also expresses an expectation as to the institution's Pillar 2 guidance (P2G).[4]

The decision on an institution-specific capital requirement and Finanstilsynet's expectation regarding the institution's Pillar 2 guidance are published on Finanstilsynet's website. Finanstilsynet's decision on an institution-specific capital requirement may be appealed within three weeks after the institution has received the decision. Appeals must be submitted to Finanstilsynet.[5] The decision on the institution-specific capital requirement is valid until a new decision is made.

## 3.3. Consolidation level

For institutions that are part of a financial services group, the assessment of risk and capital needs will normally be carried out at the highest level of consolidation, and an institution-specific capital requirement will be set at consolidated level for the institution in question. When the institution-specific capital requirement also applies at solo level, this will be specified in the decision.[6]

# 4. Principle of proportionality in the SREP

Finanstilsynet divides institutions into categories that determine the frequency and scope of SREP assessments and the dialogue with the institutions. When dividing institutions into SREP categories, Finanstilsynet will, among other things, take the categorisation of institutions according to the Capital Requirements Regulation (CRR) into consideration.[7]

Category 1 will as a rule include systemically important institutions.[8] Medium-sized and large institutions that are not included in category 1 will as a rule be included in SREP category 2. Small and less complex institutions for which Finanstilsynet considers that more frequent and regular dialogue with the board of directors and management is necessary, shall as a rule be included in SREP category 3 (enhanced monitoring). Other small and medium-sized institutions are included in SREP category 4. When determining which category the institutions belong to, Finanstilsynet considers the institution's size, business model and type

[2] CRR/CRD Regulations section 46, CRD Article 97

[3] CRR/CRD Regulations, section 46, CRD Article 104a, cf. Articles 73, 74 and CRR Article 393. See also chapter 12 on supervisory measures.

[4] CRR/CRD Regulations, section 47, CRD Article 104b (2)

[5] The appeal authority is the Ministry of Finance

[6] An ICAAP must nevertheless be prepared for each institution, cf. Appendix 1.

[7] CRR Article 4 nos. 145 and 146:  Large, small, less complex and other institutions

CRR/CRD Regulations, section VIII

of business, as well as risk exposure. Finanstilsynet will also take other factors into account, such as whether the institution is newly established.

Finanstilsynet assesses the classification criteria and the basis for assigning institutions to the various categories on an annual basis. If the criteria and/or the assignment to a specific category are changed, Finanstilsynet will inform the institutions concerned. The institutions category affiliation is not disclosed.

Table 1 summarises the frequency and scope of SREP assessments and Finanstilsynet's dialogue with the institutions by category.

**Table 1: Frequency and scope of SREP assessments and follow-up of the institutions**

| SREP – Finanstilsynet's follow-up of the institutions | | | | |
|---|---|---|---|---|
| Category | Monitoring of key performance indicators | SREP and Pillar 2 decision | Risk assessment | Scope of contact with the institution |
| 1 | Quarterly | Annually | Annually | Regular dialogue with the institution's board and management |
| 2 | Quarterly | Every second year | Annually | Regular dialogue with the institution's board and management |
| 3 | Quarterly | Every third year | Annually | Regular dialogue with the institution's board and management |
| 4 | Quarterly | Every third year | Annually | Risk-based dialogue with the institution's board and management |

The frequency of the SREP reviews may occasionally deviate from that shown in table 1. For example, there may be a need for a new SREP earlier than the normal frequency would indicate when the institution's risk level has changed significantly, or when the institution has undergone major structural changes (merger, purchase/sale of portfolios etc.) that have resulted in a material change in the overall risk level. A new review will normally cover all risk areas.

The SREP review is based on the principle of proportionality. As a rule, Finanstilsynet's risk assessments of large and complex institutions are more detailed and include more risk elements than for small and less complex institutions. The risks described in chapter 8 may be less relevant for some institutions. In other cases, a more thorough risk assessment may be required for small and less complex institutions, or institutions with a simple business model but a high risk exposure.

# 5. Ongoing monitoring

Finanstilsynet regularly tracks selected risk indicators and financial key figures for individual institutions, such as key figures for capital, liquidity, funding, profitability, growth, credit risk and market risk. The indicators are based on the institutions' reporting to Finanstilsynet. Finanstilsynet monitors the level of the indicators and how the indicator values develop over time. The indicators are also compared across institutions by using selected reference groups.

In addition to assessing and analysing risk developments in individual institutions, Finanstilsynet monitors developments in the Norwegian and international economies and assesses financial trends that may affect risk in Norwegian institutions.[9]

Based on the ongoing monitoring, Finanstilsynet assesses the need for supervisory follow-up, including the assignment to SREP categories and other supervisory measures.

# 6. Assessment of business model

As part of the SREP, Finanstilsynet assesses the institution's business model and overall strategy, including the business model's robustness in the short and long term.[10] Finanstilsynet also assesses capital needs related to business and strategic risk, as well as ownership risk. As a rule, the assessment covers the institution's entire operations, including relevant wholly and partly owned entities. In some cases, Finanstilsynet also carries out thematic assessments of groups of institutions.

## 6.1. Assessment of business and strategic risk

Finanstilsynet shall analyse the institution's business model, strategy and financial plans, and whether the business model and strategy are viable and sustainable over time, cf. the EBA's SREP guidelines, title 4. As far as viability is concerned[11], the institution's current business model and its ability to generate acceptable returns over the following twelve months are analysed, while the analysis of whether the business model / strategy is sustainable[12] is based on a longer-term perspective.[13] The purpose of the assessment is to obtain an overview of the risks the institution is or may be exposed to, possible weaknesses and vulnerabilities, and the institution's earnings capacity, as well as its ability to generate future capital/profits, given the institution's risk appetite and funding position. The analysis forms the basis for an assessment of business and strategic risks, which are not covered in Pillar 1. Finanstilsynet makes a comprehensive assessment which may include

- an overarching analysis of the business model and which areas should be subject to further consideration
- strategic, market and regulatory parameters
- strategy and financial plans, including planned changes in the institution's business model, growth and entry into new products and markets
- the institution's distribution model and exposure outside its core geographical area
- links to third parties, including the scope of outsourcing, cooperation agreements and joint ownership with other entities
- how different customer segments and products contribute to the institution's profitability, risk profile, balance sheet structure, etc., including whether the business model is unbalanced and insufficiently diversified

[9] Finanstilsynet's assessment of the stability of the Norwegian financial system is published twice a year in the 'Risk Outlook' report.

[10] The EBA recommends that the institutions extend the time horizon for strategic planning to at least 10 years, cf. the EBA 'Report on Management and Supervision of ESG Risks for Credit Institutions and Investment Firms' (EBA/REP/2021/18) See also CRD 6, article 87a.

[11] See EBA/GL/2022/03, section 71.

[12] See EBA/GL/2022/03, section 71.

[13] Finanstilsynet is conscious of avoiding double counting when assessing capital needs. The risk shall be reflected in the institution-specific Pillar 2 requirement or in the expected Pillar 2 guidance.

Finanstilsynet assesses whether the institution has incorporated ESG risks[14] in its business model and strategy. Finanstilsynet assesses whether environmental, social and governance factors affect the viability and resilience of the institution in the short and long term.[15]

The analysis of the business model also comprises an assessment of whether it includes aspects that may involve a particular risk of money laundering and terrorist financing. The institution's customer base, geographical conditions, products and service offering are examples of relevant information that can be used as a basis for assessing whether the institution's business model entails an institution-specific risk of money laundering and terrorist financing.[16]

Finanstilsynet also takes account of the measures implemented by the institution to mitigate risk and vulnerabilities based on the institution's business model and strategic choices, and of whether the institution's business model and strategy could entail reputational risk.

## 6.2. Assessment of ownership risk

Finanstilsynet also assesses risk associated with the institution's ownership interests in wholly and partly owned institutions in cases where the ownership is not regarded as a purely financial investment but appears to be a strategic investment.[17] In its assessment, Finanstilsynet considers whether ownership, directly or indirectly, may contribute to heightening risk due to changes in liabilities, earnings and profits. Finanstilsynet also factors in any financial and legal obligations between the institutions that may affect ownership risk. In some cases, ownership may also entail a risk of loss of reputation.

# 7. Assessment of internal governance

SREP includes an assessment of the institution's internal governance system. For a more detailed description of the assessment criteria that are emphasised, see Finanstilsynet's risk module published on Finanstilsynet's website[18] and the EBA's SREP guidelines.[19] The assessment is based on available documentation, such as the institution's ICAAP and ILAAP, its reporting to Finanstilsynet, documentation from on-site inspections and publicly available information.

Finanstilsynet assesses whether the institution's organisation and lines of responsibility, as well as its policies, mechanisms and processes for governance and management, are well adapted to the institution's risk strategy, size, business model and complexity. Finanstilsynet also assesses whether the framework for risk management and internal control is in compliance with relevant legislation and covers all relevant risks, and whether it is adequately documented and implemented and complied with throughout the institution/group. Finanstilsynet compares the institution's actual risk to its approved risk appetite and assesses whether the risk appetite framework clearly correlates with the overarching business and risk strategy and to its remuneration schemes.

In addition to setting minimum requirements for policies and procedures for the various risk categories in compliance with section 36 of the CRR/CRD Regulations, Finanstilsynet assesses whether adequate and appropriate policies and procedures have been established to ensure that the institution complies with prevailing anti-money laundering and counter-

[14] Environmental, social and governance risks

[15] EBA/GL/2022/03, section 95g.

[16] EBA/GL/2022/03, section 74.

[17] Equity price risk is assessed under market risk, cf. section 8.2

[18] Module for assessment of internal governance (in Norwegian only)

[19] EBA/GL/2022/03, title 5

terrorist financing requirements. Similarly, consideration will be given to whether adequate and appropriate policies and procedures have been adopted to ensure that sustainability (ESG) risks, including climate risk, are included in all risk assessments wherever relevant. Finanstilsynet also assesses whether the institution has incorporated targets and limits for ESG risks that are proportionate to the institution's risk appetite. It also considers whether the institution’s established internal control includes processes for recovery plans and for correcting weaknesses identified in the plan.

Finanstilsynet assesses whether the organisation of internal control functions, the resources and expertise assigned to these functions and their position in the institution ensure that they can carry out their responsibilities independently of business operations. The institution's remuneration schemes may also be reviewed as part of the SREP,

as may its corporate and risk culture. When assessing the risk culture, Finanstilsynet will, in addition to any observations of conduct, take the institution’s internal policies into consideration. These will include codes of ethics and policies for identifying and handling conflicts of interest, for example related to a sound balance between customer protection and the institution’s own interests,[20] as well as rules for loans to and other types of transactions entered into with members of the board and management and their close associates.

Finanstilsynet shall ensure that the institution has documented policies for the ICAAP and ILAAP, that it prepares an ICAAP and an ILAAP document[21] at least annually, and that these documents function as important tools in the institution's risk identification and management process. Finanstilsynet will regularly assess the ICAAP and ILAAP and whether associated internal methodology and processes are proportionate to the institution's size, scope and complexity, and that the institution carries out complete risk assessments that are well integrated in the institution’s governance and decision-making processes. The institution’s ICAAP, ILAAP and recovery plan shall be consistently documented.

Finanstilsynet emphasises the importance of the board of directors carrying through a sound process to ensure that the institution holds sufficient capital relative to its overall risk profile. In institutions that are required to have an internal audit function[22], Finanstilsynet expects this function to regularly assess whether the processes, methods and models used provide reliable input to the institution’s assessments of risk and capital and liquidity needs. Finanstilsynet expects the board to ensure that sufficient resources are allocated to audits covering ICAAP and ILAAP in the internal audit function’s plans. Finanstilsynet urges boards in institutions that are exempt from the requirement to have an internal audit function to also regularly obtain an independent assessment of whether the processes, methods and models used provide reliable input to the institution’s assessments of risk and capital and liquidity needs. The assessment may be carried out by an external auditor or another independent party with sufficient competence.

Finanstilsynet also takes a closer look at reporting to the board and management, including the scope, relevance and quality of the reporting, as well as the board and management's response and implementation of relevant measures. In this context, the institution's systems and procedures for handling and aggregating data may also be reviewed. Finanstilsynet also assesses the quality of the institution’s external reporting.

Finanstilsynet also evaluates the institutions' stress tests, policies and procedures for conducting the stress tests and the results presented in the ICAAP and ILAAP, as well as in the institutions' risk reports. Finanstilsynet assesses whether the stress tests are in accordance with the EBA's guidelines on stress testing (EBA GL/2018/04) and whether the tests are adapted to the institution's operations and risk exposure. The results of the

[20] Financial Institutions Act, section 16-1 subsection (4)

[21] Financial Institutions Act, section 8-6 and section 13-6 subsection (1)

[22] Financial Institutions Act, section 8-16 and Financial Institutions Regulations, section 8-3 first subsection

institution's stress tests in ICAAP will also be considered against Finanstilsynet's own stress tests.

# 8. More about the different risk categories

Pursuant to the Financial Institutions Act, section 14-6 subsection (2), Finanstilsynet shall assess all risks to which institutions are or may become exposed. The assessment of future risk to which the institution may be exposed will take the institution's business model, strategy and the macroeconomic situation into consideration. As a rule, Finanstilsynet divides its assessment of the institution's inherent risks into the following subcategories: business and strategic risk, including ownership risk and reputational risk, credit risk and concentration risk, market risk, operational risk, liquidity risk and funding risk, risk of excessive leverage and ‘other risks’. ESG risk includes risks related to climate and nature and social and governance matters and is a risk driver within the risk areas to which institutions are exposed.[23]

If weaknesses have been identified in the institution's management and control of the individual risk categories referred to in chapter 8, Finanstilsynet will take into consideration the risk this may entail for the institution. For small and non-complex institutions, Finanstilsynet's makes an overall assessment of the institution’s internal governance, including risk related to the management and control of the individual risk categories.

For a more detailed description of the criteria that are emphasised in the assessment of the management and control of credit risk, market risk, liquidity and funding risk, and operational risk, see Finanstilsynet's guidelines (modules) published on Finanstilsynet's website[24] (in Norwegian only) and the EBA’s SREP guidelines.[25]

This chapter specifies the criteria that may be relevant when assessing the institution's risk exposure. The assessment of strategic and business risk, including ownership and reputational risk, is discussed in Chapter 6. The assessment of internal governance is described in chapter 7.

## 8.1. Credit risk

**Management and control of credit risk and portfolio quality**

In its analysis of the institution's credit risk exposure, Finanstilsynet assesses the quality of and developments in the institution’s various credit portfolios and their outlook. Finanstilsynet's module for assessing credit risk provides further guidance on which elements Finanstilsynet attaches importance to. See also the EBA's SREP guidelines.

Finanstilsynet assesses the institution's actual risk exposure, as well as how the institution's credit risk is monitored and reported. The actual risk exposure is compared with the board’s risk appetite, credit strategies and credit procedures as well as the institution’s estimated capital needs for portfolio quality in the ICAAP. Finanstilsynet also assesses risk exposure in a forward-looking perspective in light of the institution's credit strategies, credit limits and the macroeconomic outlook.

Finanstilsynet’s assessments are based on section 6.2 of the EBA’s SREP guidelines (EBA/GL/2022/03) and emphasise the following:

[23] EBA Report on Management and Supervision of ESG Risks for Credit Institutions and Investment Firms (EBA/REP/2021/18)

[24] Risk modules

[25] EBA/GL/2022/03, sections 6.2 (credit risk), 6.3 (market risk), 6.4 (operational risk) and 6.5 (market risk)

- Non-performing exposures and how long they have been non-performing, cf. EBA/GL/2022/03, sections 210 and 211. According to Finanstilsynet's assessment, a high percentage of non-performing exposures may indicate that the institution accepts customers with higher risk than its peers. This risk will be partially covered through Pillar 1 by assigning a higher risk weight to exposures when they are classified as non-performing. The risk weight is thus conditional on the level of provisioning and on whether the exposure is already classified as high risk under CRR Article 128.
- Forborne exposures, cf. EBA/GL/2022/03, section 209.
- The fact that the Pillar 1 requirements in principle shall cover *unexpected losses* but do not take into account that there may be substantial uncertainty related to the level of provisions required to cover *expected losses*, including weaknesses in the institution's loss models, estimates or procedures that may contribute to expected losses being underestimated. As an example, the following is considered:
  - The level of loan loss provisioning on the institution's performing high-risk portfolio[26] and the level of provisioning on older non-performing loans. The assessments are made for both the overall portfolio and for relevant sub-portfolios. When assessing the level of provisioning, existing collateral and valuations, as well as relevant peers' level of provisioning, are taken into account. Finanstilsynet considers whether the institution's capital needs exceed the Pillar 1 requirement, see EBA/GL/2022/03, sections 216-218.
  - Whether the institution's methodology for determining loan loss provisions is in accordance with the requirements of IFRS 9, see EBA/GL/2022/03, section 216c.
- Whether the institution's granting and monitoring of loans is in line with the EBA guidelines[27], cf. EBA/GL/2022/03, section 220 etc.
- Compliance with the Lending Regulations.[28]
- To what extent the institution differentiates the pricing of loans between loan products and between customer segments, see EBA/GL/2022/03, section 224 c) etc.
- The institution's exposures to commercial property and property development projects[29], cf. EBA/GL/2022/03, section 228 etc.
- Possible securitisation of portfolios and how this affects the risk to which the institution is exposed, cf. EBA/GL/2022/03, sections 193-195.
- Whether the institution has assessed ESG risk[30] in its credit portfolio, e.g. whether environmental, social and governance factors have been taken into account when assessing collateral values and customers' debt servicing capacity.
- Whether the institution has assessed the risk that the customer will not be able to refinance on the contractual date, whereby the loan will have to be extended beyond the contractual maturity. This should be considered, for example, in situations where
  - the customer has short-term loans, but needs long-term financing
  - there are sizeable repayments on the loan towards the end of the contract period and it is assumed that the loan is renewed or that the customer obtains new financing. Obtaining new financing may be demanding, especially if the

[26] According to Finanstilsynet's measurement method

[27] EBA/GL/2020/06

[28] Regulations of 9 December 2020 no. 2648

[29] Finanstilsynet's Circular no. 2/2021 (in Norwegian only)

[30] Special risks associated with climate change and the transition to a low-emission society

risk is high or has increased since the existing loan was granted. See EBA/GL/2020/06, section 262.

With respect to IRB banks, Finanstilsynet will consider whether the use of contractual maturity in the capital requirements calculation (‘M parameter’) entails that the estimated capital requirement does not adequately cover the risk, cf. EBA/GL/2022/03, sections 167, 170 and 203.

In connection with the assessment of portfolio quality, Finanstilsynet has established a scoring model to identify credit risk that is not adequately reflected under Pillar 1, cf. EBA/GL/2022/03, title 6.2.2. The model includes default rate, provision rates, share of forborne exposures and probability of default in the corporate portfolio. The scores in the model are not automatically reflected in Finanstilsynet’s assessment of increased capital needs to be taken into account in Pillar 2. The scoring model is primarily used to identify institutions that will be subject to further assessment.

When assessing portfolio quality, Finanstilsynet places particular emphasis on the institution’s own risk assessment and estimated capital needs in the ICAAP, as well as observations from on-site and off-site inspections, information from external reporting and any comments from the auditor. Finanstilsynet focuses especially on whether the institution’s loss models, procedures and practices adequately capture exposures with a material increase in credit risk and exposures that are credit-impaired, as well as the risk that the institution underestimates expected losses on non-performing exposures. Finanstilsynet considers the institution’s risk pricing and ability to take debtors’ high/increasing risk into account. The model is used as a support tool in the process to set institution-specific capital requirements for portfolio quality. For IRB institutions, assessments of potentially higher capital needs are seen in connection with assessments of model risk.

For institutions whose IRB model has been approved, Finanstilsynet's general follow-up of the institutions' use of the models will be taken into account in the risk assessment. Finanstilsynet will also consider whether special measures are required as part of the SREP (model risk). Model risk will primarily be considered under Pillar 1 (for example by including margins of conservatism in the models). The institutions themselves may choose to set risk weights and risk parameters higher than what follows from the individual provisions of the Capital Requirements Regulation since, according to Article 3 of the regulation, these are minimum requirements. If significant deficiencies are identified in an institution’s IRB methodology, Finanstilsynet will continuously assess measures, including the need for measures under Pillar 2. In cases where the deficiencies are considered to be of a temporary nature, Finanstilsynet will assess the need for temporary measures under Pillar 2 until the deficiencies have been corrected and the models reflect the actual risk.[31]

### Credit-related concentration risk

When assessing the institution's credit-related concentration risk, Finanstilsynet considers whether the institution’s exposures are broadly diversified.[32] High concentration risk could make the institution particularly vulnerable. The analysis includes single-name concentrations, sectoral concentrations, geographical concentrations, product concentrations and collateral and guarantee concentrations. Finanstilsynet also assesses the volume of large exposures[33] and their quality. Finanstilsynet’s methods for single-name concentration and sector concentration are described in Appendix 2.

### Other credit risk

Finanstilsynet assesses the risks associated with persistently high lending growth, cf. EBA/GL/2022/03, section 207 b). For lending in foreign currency, Finanstilsynet factors in

[31] EBA/GL/2022/03, sections 182 and 229.

[32] EBA/GL/2022/03, sections 183-189.

[33] CRR Article 393

exchange rate changes affecting the portfolio during periods of high lending growth. Partially-owned covered-bond-issuing entities should not need additional capital to cover lending growth as such growth is taken into account in assessments of the individual parent bank. Finanstilsynet also considers whether the capital requirement in Pillar 1 for off-balance sheet items is sufficient, cf. EBA/GL/2022/03, section 169. Finanstilsynet's methods are described in detail in Appendix 2.

Furthermore, Finanstilsynet makes a discretionary assessment of whether the institution is subject to counterparty risk (e.g. from derivatives), which is not sufficiently covered under Pillar 1, cf. EBA/GL/2022/03, sections 190-191.

## 8.2. Market risk

Finanstilsynet assesses whether there are exposures to market risk in or off the institution's balance sheet that are not sufficiently covered by the general capital requirements. The analyses of the individual types of market risk include assessments of potential losses in the event of sudden changes in key market risk factors. The assessment also examines how risk diversification and liquidity in the positions may affect the loss potential. Finanstilsynet also considers the need to strengthen the institution's management and control of market risk.

The market risk assessment is carried out for activities in the trading book and ordinary banking activities (banking book). Finanstilsynet also includes property risk in its assessments of market risk in the banking book. Finanstilsynet's module for assessing market risk provides further guidance on which elements Finanstilsynet attaches importance to.[34] See also the EBA's SREP guidelines.[35] Finanstilsynet's methods are described in further detail in Appendix 3.

### 8.2.1 Market risk in the trading book

For institutions with trading book activities that trigger capital requirements under CRR provisions on market risk, Finanstilsynet will assess the risk and capital requirements based on the institution's descriptions of the relevant activities, reported exposures and assessments made in the ICAAP. Finanstilsynet has not developed a specific quantitative methodology for assessing institution-specific capital requirements for market risk in trading portfolio activities.

### 8.2.2 Market risk in the non-trading book

**Interest rate risk**

Interest rate risk in the banking book36 (IRRBB) is considered to be both the risk of changes in the economic value of equity (EVE methodology) and the risk of changes in profits (NII methodology), according to the EBA guidelines. The need for capital will be assessed on the basis of the institution's reported exposures and risk limits, although other factors will also be taken into consideration. Finanstilsynet will place main emphasis on the exposure to EVE, but if there is a particularly large NII exposure, this will also be given weight. In order to ensure that institutions are treated as equally as possible, Finanstilsynet's assessment will include comparisons between institutions based on their size and business model. When assessing institutions' management and control, emphasis will also be placed on the model assumptions underlying the institutions exposure calculations.

[34] Market risk module

[35] EBA/GL/2022/03, title 6.3

[36] EBA/GL/2022/14 and the Basel Committee's document: 'Standards – Interest rate risk in the banking book, April 2016'

### Equity risk

Finanstilsynet analyses the institution's market risk associated with positions in equity instruments, including derivatives with equity instruments as underlying assets. A comprehensive assessment will be made based on the institution's actual positions, as well as portfolio concentration and estimated market liquidity. When assessing institution-specific capital needs, Finanstilsynet will pay particular attention to exposures that are not related to strategic and other ownership positions closely linked to ordinary banking operations.

### Currency risk

Finanstilsynet assesses the institution's risk associated with exposures to various foreign currencies. The assessment is based on actual positions and comprises all financial instruments and other positions entailing currency risk.

### Credit spread risk

Finanstilsynet assesses the institution's risk associated with changes in the market value of bonds, commercial paper and credit derivatives due to general changes in credit spreads. Credit spread risk in the banking book (CSRBB) is assessed according to the EBA guidelines.[37] As a rule, the assessment is based on the market value of the institution's actual positions and the institution's own assessments based on internal measurement systems.

### Property risk

Finanstilsynet assesses the institution's risk associated with positions in and direct ownership of property, including business premises owned by the institution (e.g. bank buildings and properties used by employees), property companies and repossessed properties. The analysis also includes the institution's investments in property fund units. As a rule, the assessment is based on the market value of the institution's actual holdings.

### Other market risk

Finanstilsynet also considers whether the institution is exposed to other types of market risk. For institutions with substantial international funding, it will be especially relevant to assess whether the market risk associated with this activity is adequately covered.

Commodity risk has so far represented a limited share of institutions' total market risk. A discretionary assessment will be made of institution-specific capital requirements related to commodity risk in cases where the actual exposure is of a certain significance.

For large institutions, Finanstilsynet will also assess how the institution monitors the effect of ESG risks on its market risk positions and whether the institution has established a suitable sustainability strategy for market risk.

## 8.3. Operational risk

Finanstilsynet assesses the institution's risk and capital needs related to operational risk based on the institution's own assessments, past losses, experience from inspections and

[37] EBA/GL/2022/14

other reporting. Finanstilsynet's risk module and the EBA's SREP guidelines [38] and [39] provide an overview of relevant assessment criteria.

When assessing whether the capital requirement under Pillar 1 is adequate, Finanstilsynet considers the institution's business model, internal governance, strategies and regulatory framework. Finanstilsynet also assesses whether the indicator values underlying the Pillar 1 requirement adequately reflect the scope of operations.

In the assessment, it is particularly relevant for Finanstilsynet to emphasise (not an exhaustive list):

- ICT risk
- compliance risk
- conduct risk
- risk of fraud
- legal risk
- money laundering and terrorist financing risk
- the institution's follow-up of outsourced services
- the quality of internal and external reporting
- contingency and continuity plans.
- the development and use of internal governance models
- ESG risk, including physical and transition risks associated with climate change and the transition to a low-emission society

In its assessment, Finanstilsynet attaches particular importance to potential consequences in the event of weak management and control of the above-mentioned risks.

Finanstilsynet considers whether operational events and actions may undermine confidence in the institution and are likely to result in reduced profitability in the long term. Examples can be non-compliance with sustainability standards **to be met by** the institution's products, non-compliance with the anti-money laundering legislation or poor handling of vulnerable customer groups. If Finanstilsynet considers that the institution needs to hold capital or liquid assets covering reputational risk, this will be included in the business model assessment and/or liquidity assessment.

## 8.4. Liquidity and funding risk

In its analysis of the institution's liquidity and funding risk, Finanstilsynet considers whether the institution's liquidity and funding strategy, guidelines, limits, processes and models are proportionate to its size, activities and complexity. Finanstilsynet assesses how well prepared the institution can be considered to be in a liquidity and/or funding crisis that affects the institution and/or the market in general. Furthermore, it is relevant to clarify whether the institution's liquidity and/or funding is exposed to the risk of money laundering and terrorist financing. The assessments will also include the significance of ESG risks for the institution's current status and future liquidity and funding challenges.

### Liquidity risk

Finanstilsynet analyses the institution's framework, developments in and status of the liquidity coverage ratio, LCR, in total and per significant currency, at all levels of consolidation. The institution is therefore expected to account for the status or, for smaller entities, the estimated status of the total LCR at all consolidation levels at the end of each

[38] EBA/GL/2022/03, title 6.4

[39] EBA/GL/2017/05

day (business days) throughout the year. This also applies to the LCR in NOK if the institution is subject to Pillar 2 requirements for LCR in NOK, see chapter 11.

Furthermore, the institution’s framework, developments in and status of other liquidity reserves are assessed, including spare covered bond capacity and the effects of sudden reductions in the liquidity reserve. Finanstilsynet expects the institution's framework and compliance therewith to address risks posed by concentrations of liquid assets, mismatches between currency flows and intraday liquidity risk.

#### Funding risk

Finanstilsynet analyses the institution’s framework, developments in and status of stable long-term and diversified funding on the basis of the net stable funding ratio (NSFR), the deposit-to-loan ratio and the composition of deposits. Other factors that are taken into account are the share of market funding, the average remaining maturity of market funding, the concentration in maturity structure, including funding reaching maturity within one year, and the diversification of funding sources, including international funding. The assessment of market funding includes an evaluation of possible requirements imposed on the institution with respect to subordinated debt (MREL).

## 8.5. Risk of excessive leverage

Finanstilsynet assesses the risk that the institution's obligations will increase too much relative to the institution’s equity, taking the institution's business model, business strategy and growth ambitions into consideration. Finanstilsynet also assesses the level of, and changes in, the institution's leverage ratio over time and compares the institution's leverage ratio with a reference group. It will also be relevant to assess the level of the institution's exposure measure relative to risk-weighted assets. Developments in the institution's leverage ratio in Finanstilsynet's stress tests will be given weight in the risk assessment.

## 8.6. Other risk areas

#### Risk associated with pension obligations

Finanstilsynet assesses the risk associated with the institution's future pension obligations and whether this may give rise to unexpected future costs for the institution. Institutions that sponsor pension funds or have non-funded pension schemes for their employees (including contractual early retirement schemes – AFP) and institutions with defined benefit pension schemes and hybrid occupational pension schemes are considered to be subject to risk related to their pension obligations.

#### Other risks

Finanstilsynet may also assess material risks other than those mentioned above when this is relevant and in accordance with the prevailing SREP guidelines from the EBA.

# 9. Overall risk assessment

In the risk assessments described in chapter 6 (business model), chapter 7 (internal governance) and chapter 8 (more about the different risk categories), Finanstilsynet ranks the institution's total risk in one of four categories: ‘low risk’, ‘medium to low risk’, ‘medium to high risk’ or ‘high risk’. Liquidity and funding risk is ranked separately. Together, Finanstilsynet's assessments form the basis for an overall SREP score that gives Finanstilsynet a starting point for comparing and assessing risk and capital needs across different institutions and groups of institutions. The overall risk assessment is an internal document and is not published.

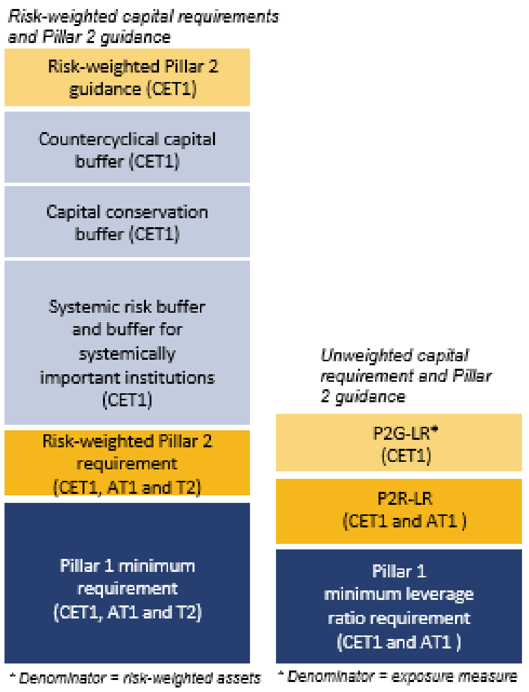
# 10. Assessment of overall capital needs

## 10.1. Introduction

Finanstilsynet's assessment of the institution’s business model (chapter 6) and internal governance (chapter 7), together with the risk assessment of the institution (chapters 8 and 9) form the basis for assessing the institution's overall capital need, its capital need under Pillar 2 and its Pillar 2 guidance.

Chart 2 is an illustration of the institution’s total capital need and Pillar 2 guidance. The chart also illustrates the Pillar 2 requirement for the risk of excessive leverage (P2R-LR) and the Pillar 2 guidance for the risk of excessive leverage (P2G-LR).

**Chart 2: Overview of capital requirements and Pillar 2 guidance**




CET1 = common equity Tier 1 capital, AT1 = other eligible Tier 1 capital, T2 = Tier 2 capital

## 10.2. Assessment of capital needs under Pillar 2

### Determining institution-specific capital requirements and the composition of capital

Capital needs for risks that are not covered, or are only partially covered, by the minimum and buffer requirements under Pillar 1 shall be set as institution-specific capital requirements (Pillar 2). This section describes the type of capital that can be used to meet the requirement for additional capital under Pillar 2 and Finanstilsynet's procedure for determining the institution-specific capital requirement. Finanstilsynet is conscious of avoiding double counting when assessing capital needs. The Pillar 2 requirement shall not include elements of systemic risk.[40]

The institution-specific capital requirement applies at the highest level of consolidation unless otherwise specified in Finanstilsynet's decision. Capital used to meet the minimum requirement under Pillar 1 and the overall buffer requirement cannot be used to cover the

[40] EBA/GL/2022/03, section 401

need for capital under Pillar 2. Capital used to meet the risk-weighted institution-specific capital requirement shall consist of a minimum of 56.25 per cent CET1 capital and 75 per cent Tier 1 capital, which corresponds to the capital composition requirement under Pillar 1.[41]

Finanstilsynet may set stricter requirements for the composition of capital for individual institutions when this is warranted by institution-specific circumstances and is necessary in order to maintain the institution's capital adequacy.[42] The EBA's SREP guidelines refer to the composition of own funds in sections 390, 391 and 417. As a result of institution-specific circumstances, it may be relevant, for example, to impose stricter capital composition requirements to meet the institution-specific capital requirement due to

a. the specific nature of the institution, its shareholders and, where relevant, the structure of the group, potentially affecting the possibility to raise capital depending on the characteristics of certain capital instruments, or

b. the specific nature of risk faced by the individual institution, potentially leading to particularly rapid depletion of CET1 capital

In its assessment, Finanstilsynet takes into account whether the institution's ownership structure may have a strong impact on the institution's access to (common equity) Tier 1 capital and/or the institution is assumed to have particular challenges raising new capital. Other factors that Finanstilsynet may consider are whether the institution has a risk profile that could cause rapid and significant fluctuations in its CET1 capital ratio. This may also be relevant for institutions that for other reasons are especially vulnerable to a decline in its CET1 capital ratio. Finanstilsynet will take account of any legal, operational and financial factors that may affect the institution's capital level and/or ability to raise Tier 1 capital. The requirement for the composition of capital under Pillar 2 will be set out in Finanstilsynet's decision for the individual institution and will apply until a new decision is made.

Based on the risk assessment referred to in chapters 8 and 9, Finanstilsynet assesses the individual institution's capital needs under Pillar 2. For each risk type, an assessment is made of whether the capital allocated under Pillar 1 is sufficient to cover the risk to which, in Finanstilsynet's opinion, the institution is exposed. For certain types of risk that are not covered or not sufficiently covered under Pillar 1, Finanstilsynet has developed a calculation methodology that is used as a support tool in the assessment of capital needs. The methodology is described in further detail in the appendices to this guidance. This applies to

- credit risk – see Appendix 2 for further details
- market risk – see Appendix 3 for further details
- ownership risk related to ownership in insurance undertakings – see Appendix 4 for further details

Together with the criteria referred to in chapter 8 and the criteria set out in Finanstilsynet's modules, these methods form the basis for Finanstilsynet's overall assessment of the institution's capital needs, including capital needs under Pillar 2. In its assessment, Finstilsynet also takes account of the institution's internal capital adequacy assessment process (ICAAP).

If the institution fails to comply with requirements concerning its internal governance or recovery plan[43], assessments of risk and overall capital needs[44], or the rules on large

[41] CRR/CRD Regulations, section 46, fifth subsection

[42] CRR/CRD Regulations, section 46 fifth subsection third sentence, cf. CRD Article 104a no. 4, third subsection

[43] Financial Institutions Act, chapter 13 and section 20-5, cf. CRD Article 74.

[44] Financial Institutions Act, section 13-6, cf. CRD Article 75. See Appendix 1.

exposures[45], and other  supervisory measures are not considered appropriate, Finanstilsynet will lay down an institution-specfic capital requirement.[46] Requirements concerning institutions' ICAAP are discussed in further detail in Appendix 1.

**Temporary institution-specific capital requirement**

In some cases, Finanstilsynet may lay down a temporary institution-specific capital requirement.[47] It follows from the CRR/CRD Regulations, section 46 second subsection that Finanstilsynet may decide that the Pillar 2 requirement shall apply temporarily or until special conditions are met. This means that the Pillar 2 requirement may be eased or increased in the period between two SREP reviews if, during this period, changes occur in the risk to which the institution is exposed.

Temporary institution-specific capital requirements are particularly relevant when other supervisory measures are considered insufficient or inappropriate. Finanstilsynet may also make decisions on temporary institution-specific requirements outside the ordinary SREP. It is particularly relevant to lay down temporary institution-specific capital requirements for risk related to the institution's business model (chapter 6), internal governance (chapter 7), weaknesses in internal models (section 8.1) and compliance with the anti-money laundering (AML) legislation (section 8.3).

## 10.3. Leverage ratio

Capital needs arising from the risk of excessive leverage are assessed separately from the other risk categories. The leverage ratio is a solvency indicator that supplements the risk-weighted minimum requirements and is intended to function as a backstop for risk-weighted exposures that restricts institutions' leverage during upturns.[48]

Finanstilsynet shall set an institution-specific leverage ratio requirement. The institution-specific leverage ratio requirement is intended to cover risks that are not covered, or are only partially covered, by the Pillar 1 requirement for the risk of excessive leverage.[49] In its assessment, Finanstilsynet places emphasis on vulnerabilities in the institution's operations, business model, strategies, forecasts and growth plans that are not captured by the risk-weighted capital requirement.[50] Finanstilsynet also assesses whether there are any signs of adjustments in exposures around the reporting dates that indicate that an institution-specific leverage ratio requirement should be set. In addition, Finanstilsynet assesses developments in the institution's leverage ratio over time.

Finanstilsynet assesses the overall level of the institution's leverage ratio in light of the intention to reduce excessive leverage.

[45] Financial Institutions Act, section 13-12, cf. CRR/CRD Regulations, section 44, CRR Article 393 and EBA/GL/2017/15

[46] CRR/CRD Regulations, section 46.

[47] CRR/CRD Regulations, section 46 second subsection second sentence. Cf. EBA/GL/2022/03 nos. 386, 387 and 549

[48] CRR, section 8 of the preamble

[49] CRR/CRD Regulations, section 46, fourth subsection

[50] EBA/GL/2022/03, section 7.3

# 11. Other measures under Pillar 2

## 11.1. Pillar 2 requirements for LCR in foreign currency

As of 1 January 2025, section 11 of the CRR/CRD Regulations on liquidity coverage requirement (LCR) in significant currencies has been revoked, and a Pillar 2 requirement will be imposed on the liquidity coverage requirement in significant currencies. Currencies which account for more than 5 per cent of an institution's total liabilities are considered to be significant currencies.

There are no changes to the requirement that the total liquidity coverage requirement, LCR total, at all times shall be minimum 100 per cent, cf. the CRR/CRD Regulations, section 2 second subsection no. 2, (cf. Commission Delegated Regulation (EU) 2015/61, Article 4)

As of 1 January 2025, the main principles for the SREP outlined below apply. These will be used in Finanstilsynet's decisions on Pillar 2 liquidity requirements for individual institutions:

- Institutions whose liabilities in full, or practically in full, are denominated in Norwegian kroner (NOK) should have a total LCR that consists mainly of liquid assets in NOK.
- Institutions that have significant currencies other than NOK should have an LCR of minimum 100 per cent for these currencies and an LCR for NOK of minimum 50 per cent.
- Banks with a special LCR requirement in NOK of minimum 50 per cent that are allotted F-loans issued by Norges Bank may, when calculating the LCR in NOK, disregard the unwind mechanism set out in Article 17(2) of Commission Delegated Regulation (EU) 2015/61 with respect to the F-loan.

However, when calculating the total LCR, the unwind mechanism set out in the Commission Delegated Regulation apply.

The Pillar 2 requirements for LCR for significant currencies apply to banks, mortgage companies and financial holding companies that are not insurance groups, at all levels of consolidation.

# 12. Supervisory measures

As part of the SREP, Finanstilsynet assesses whether it is necessary to implement institution-specific measures to compensate for, or reduce, the risk to which the institution is exposed.

Finanstilsynet considers possible measures in light of the institution's size, complexity and business model. Finanstilsynet also assesses the severity of each case.

## 12.1. Ordinary supervisory measures, including orders for corrective measures

Finanstilsynet regularly applies relevant supervisory measures as part of its ordinary supervisory activity.[51] Establishing institution-specific capital requirements can be one of several supervisory measures. Other measures could be closer dialogue with the institution's board of directors and management, requirements for more frequent reporting, on-site or off-site inspections or orders for corrective measures. In special cases, more invasive measures may also be relevant. Finanstilsynet may communicate that the institution should improve its

[51]The Financial Supervision Act and the Financial Institutions Act, sections 10-6, 13-6 and 14-6 provide the legal basis for Finanstilsynet's authority and use of policy instruments. See also the CRR/CRD Regulations, sections 46 and 47.

internal governance, reduce its risk exposure, increase its loan loss provisions or implement other risk-mitigating measures.

Finanstilsynet may also state that the institution should implement measures to improve liquidity, set higher LCR and NSFR requirements, or change the composition of its funding. Finanstilsynet may also order the institution to strengthen its capital adequacy or not weaken it through dividend payments.

If the institution's total capital adequacy ratio falls below the sum of the minimum requirement under Pillar 1 and Pillar 2 and the buffer requirements, the institution shall immediately implement the necessary measures to rectify this.[52] Where an institution falls short of requirements or buffer requirements or is likely to do so in the near future, Finanstilsynet may order the institution to change the organisation, management and control of the business, strategies, processes, policies and procedures, change or scale down the institution's activities and/or risk exposure or implement measures to strengthen capital adequacy, for example by limiting dividend payments and the scope of the institution's remuneration schemes.

If the institution fails to establish a sufficient margin to the capital requirements, or repeatedly has a Pillar 2 guidance that is lower than expected by Finanstilsynet, Finanstilsynet may set an additional capital requirement under Pillar 2.[53]

Finanstilsynet may, when necessitated by the institution's financial position, order the institution to pay less dividend or not to pay dividend.[54] Finanstilsynet may also require institutions to maintain own funds higher than the statutory minimum requirements.[55] Automatic restrictions on overall disbursement of dividends, interest on Tier 2 capital and performance-based remuneration are triggered by failure to comply with the minimum Pillar 1 and Pillar 2 requirements and the buffer requirements.[56] If an institution fails to meet the combined capital buffer requirement, a plan for increasing CET1 capital shall be sent to Finanstilsynet within five business days after the date of non-compliance.

## 12.2. Early intervention

The Financial Institutions Act, sections 20-11 and 20-12 provide the legal basis for more invasive measures aimed at preventing financial problems in individual institutions from developing into a crisis and possibly spreading to the rest of the financial system, so-called 'early intervention'.

Just like section 14-6, section 20-11 of the Financial Institutions Act is also applicable when the institution infringes statutory requirements or is likely in the near future to infringe such requirements. However, the supervisory measures under section 20-11 are somewhat different and in some cases more invasive than the measures warranted in section 14-6, and are primarily used in situations where there is a risk of a rapid deterioration in the institution's financial position or serious administrative failures have been identified in the institution. As noted in Prop. 159L (2016-2017) section 6.7.1.1 (in Norwegian only), situations may arise where there may be grounds for intervention pursuant to both section 14-6 and section 20-11 of the Act. The proposition shows examples of situations where there is a risk of infringement of requirements for satisfactory operation other than capital requirements. In such cases, the conditions for intervention under the two provisions will be met

[52] Financial Institutions Act, section 14-6 subsection (3)

[53] Financial Institutions Act, section 13-6 subsection (7), Financial Supervision Act, section 4 fourth subsection, CRR/CRD Regulations, section 46 first subsection (e)

[54] Financial Institutions Act, section 10-6

[55] Financial Supervision Act, section 4 fourth subsection

[56] Financial Institutions Act, section 14-3 and the CRR/CRD Regulation, section 10

simultaneously, and Finanstilsynet will be able to take whatever measures it deems appropriate based on the prevailing situation.

If necessary, Finanstilsynet may ask the institution to update its recovery plan or implement specific measures to restore the institution's position, draw up an action plan for such measures, and convene the general meeting at shorter notice than laid down in the articles of association, cf. the Financial Institutions Act, section 20-11. Finanstilsynet may also ask the institution to draw up a plan for restructuring of debt and present a statement of financial position or engage independent experts to examine and assess the institution's financial situation.

The instruments warranted in section 20-12 will only apply where there is a significant deterioration in the institution's financial situation or where there are serious infringements of Acts or regulations and the measures under section 20-11 are not considered sufficient to rectify the situation. Pursuant to the Financial Institutions Act, section 20-12, Finanstilsynet may then issue an order requiring changes to be made to the composition of the board of directors or senior management, and Finanstilsynet may appoint an administrator to take charge of the activity of the institution for a period of up to 12 months.

# 13. SREP assessment in supervisory colleges

With regard to groups for which supervisory colleges have been established drawing participants from a number of European countries' supervisory authorities, Finanstilsynet's work adheres to the relevant European guidelines[57], including guidelines for the SREP. The SREP for such groups is based on the same elements and assessments as those described in this guidance. In addition, the distribution of tasks between the various supervisory authorities is specified. Assessments and decisions are documented in separate templates that follow European standards.

The home country's supervisory authority conducts a preliminary risk assessment of the parent company and the group. The supervisory authorities in the relevant host countries conduct a similar risk assessment of the group's activities that are subject to their supervisory authority (subsidiaries at the solo or sub-consolidated level, as well as some branches of foreign institutions[58]). The assessment forms the basis for the supervisory college's joint decision on the group's overall risk level, capital needs, liquidity and funding needs, both at group level and for underlying subsidiaries. The supervisory college also considers the further follow-up of the group, including relevant measures for the various entities included in the group.

[57] Based on Articles 113 and 116 of the CRD.

[58] CRD Article 51

**Appendices:**

The appendices to this guidance are published on Finanstilsynet’s website together with the guidance.

Appendix 1 Documentation of risk profile and capital needs (ICAAP and ILAAP)

Appendix 2 Finanstilsynet's assessment of Pillar 2 capital needs for credit risk

Appendix 3 Finanstilsynet's assessment of Pillar 2 capital needs for market risk

Appendix 4 Finanstilsynet's assessment of Pillar 2 capital needs related to ownership in insurance undertakings

Appendix 5 Finanstilsynet's assessment of the Pillar 2 guidance

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# Appendix 1: REQUIREMENTS FOR INSTITUTIONS' ICAAP AND ILAAP

## General information

Institutions shall assess risk and the associated capital needs on a regular basis, cf. the Financial Institutions Act, section 13-6, subsections (1) to (3). The institution shall have own funds appropriate to the risk inherent in and the volume of the activities carried on by the institution and ensure prudent liquidity management, cf. the Financial Institutions Act, section 13-7 and part V of the CRR/CRD Regulations.

Capital needs shall be assessed at consolidated level and include all group entities, cf. the CRR/CRD Regulations, section 23. The names of all group entities must be stated in the ICAAP and ILAAP. The ICAAP and ILAAP shall show the distribution of risk and capital needs for the entire group and for each of the main entities in the group, cf. the CRR/CRD Regulations, section 23. Finanstilsynet expects the ICAAP to include an overall schematic overview of risk and capital needs broken down on each risk element and each entity covered by the ICAAP. In addition to group entities, the ICAAP shall also include an assessment of risk and capital needs related to ownership interests in affiliates and cooperating groups, cf. the Financial Institutions Act, section 17-13.

The institution's assessment of liquidity and funding risk, ILAAP, is intended to help ensure that the institution has sufficient liquidity and funding, as well as sound management and control, given the various challenges it is facing or may face in the future. The ILAAP can be carried out parallel to the ICAAP and be included in the same document as a separate chapter. The methods for identifying and quantifying risks in the ILAAP must be adapted to operations, taking their complexity into consideration.

The institution's ICAAP and ILAAP shall be in keeping with its recovery plan (e.g. in terms of limits, goals and threshold values).

The documentation shall include an overall assessment of the institution's financial situation, including its strategic and market position, the quality of its assets and its likely profit growth over the next few years. The institution shall comment on significant risks and explain why the level of risk is acceptable and, if not, specify planned risk-mitigating measures.

For each risk type, the institution shall describe the key methods and assumptions underlying the assessment, and explain the calculations made, including an assessment of various scenarios. An account shall also be given of the calculations and assumptions that form the basis for assessing the operations of the group entities, affiliates, undertakings in cooperating groups and business areas, or for special business strategies. The institution shall use the most updated data possible and specify the reporting date for the figures that form the basis for the assessments. The ICAAP and ILAAP shall also provide an overview of events that have occurred after the reporting date that are of relevance to the assessment of risk, capital needs, liquidity or funding needs.

If the analysis reveals important themes that require further analyses and decisions, these must be specified. The documentation shall contain information on agreements and other important aspects that may affect the institution's access to capital or funding, and its opportunity to transfer capital or liquidity between business units or companies. Any obligations that may affect the institution's capital situation must also be disclosed.

The institution must state who has prepared the document, who has made the assessments and how the analysis has been carried out and checked. The institution's board of directors is responsible for ensuring that the institution has a sound and adequate ICAAP and ILAAP. The timing of the board's deliberations and decisions must be specified.

# Specifics on the ICAAP

The ICAAP shall include information on:

- The overarching targets for risk and risk appetite[1] that underlie the institution's ICAAP. The risk appetite shall, as far as appropriate, be stated for individual risks
- Whether the institution's risk management systems and processes for managing and controlling the risk to which the institution is exposed are considered to be of sufficient quality, and whether the institution has implemented special risk-mitigating measures in the relevant risk area
- The actual capital level and the composition of own funds, measured as a percentage of the consolidated basis for calculation
- Expected changes in the operating environment and business model, business strategies and plans, and the likely trend in the institution’s economic and financial position
- The institution's capital plan and plans for managing its level of capital, including planned sources of increased capital ahead, as well as its dividend strategy
- The institution’s need for capital related to various risks. In the case of a group, clear documentation should be provided of how all material portfolios and business areas are covered. The risk level and capital need for individual risks shall be specified, distributed on the various entities covered by the ICAAP. The capital need shall be compared with the minimum requirement for the relevant risk under Pillar 1. The ICAAP shall, as a minimum, cover:
    - business and strategic risk, including reputational risk
    - ownership risk, including
        - risk of fluctuations in profit contributions
        - other risk/obligations related to the institution’s ownership interests in other financial institutions
        - other risk/obligations related to the institution’s ownership interests in insurance undertakings. Calculations based on the method described in appendix 4 should be shown.
    - risk associated with weaknesses in the institution's systems for management and control of each of the risk areas
    - credit risk, including
        - portfolio quality[2]
        - counterparty risk
        - residual risk[3]
        - concentration risk (individual customers, sectors)
        - growth in lending, including growth in new markets/outside the institution’s core geographical area[4]
        - For portfolios calculated using the IRB approach: an assessment of deviations between original and actual maturity.
    - market risk in the trading book and banking book, including:
        - equity price risk
        - interest rate risk

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[1] The types of risks and how much risk the board and the institution are willing to take in order to reach their strategic goals. The institution's risk appetite should be formulated using brief, descriptive statements and be expressed as the limits set for loss potential, exposure limits, a description of acceptable profit fluctuations during a given period of time etc.

[2] In connection with the assessment of portfolio quality, the institution should make a more thorough assessment of the extent of forbearance and provisions on non-performing loans, as well as the uncertainty associated therewith. The institution should also make a special assessment of the quality of its financing of property development projects. In institutions where the volume of non-performing exposures (NPEs) exceeds 5 per cent of total exposure, the institution is expected to prepare a NPE strategy and action plan, cf. EBA/GL/2018/06, chapters 4 and 5.

[3] Residual risk is defined as the risk that collateral taken into account when determining the capital requirement for credit risk will be less effective than expected.

[4] Institutions with loans in foreign currency must document the effects of exchange rate fluctuations.

    - credit spread risk
    - currency risk
    - property risk[5]
  - operational risk, including:
    - summary of the institution's self-assessment of management and control of operational risk (risk related to ICT, outsourcing, changes in products/systems/market area, behavioural risk, model risk, inadequate compliance with internal and external regulations, etc.)
    - event history (potential and actual losses)
    - description of the institution's systems, processes and procedures for monitoring and reporting risk indicators as well as procedures for assessing key controls
    - the extent to which internal models are used to quantify operational risk
  - scenario analyses with descriptions of any corrective measures aimed at avoiding/mitigating risk
  - risk associated with pension obligations, e.g. risk related to defined-benefit and defined-contribution pensions, any sponsorship obligations related to pension funds and contractual early retirement (AFP) schemes
  - risk of excessive debt accumulation, including risk factors that may affect developments in the institution's leverage ratio over time
  - analysis of any fluctuations in the institution's leverage ratio
  - ESG risk, including climate and nature risks, expected to be assessed under the individual risk areas
  - the risk of money laundering and terrorist financing, expected to be assessed under the individual risk areas
- The institution's total need for risk-weighted capital. The institution must assess whether its total need for risk-weighted capital seems reasonable in light of relevant sensitivity analyses and stress scenarios.
- The institution's leverage ratio requirement. The institution must assess whether its overall leverage ratio requirement seems reasonable in light of relevant sensitivity analyses and stress scenarios.
- The institution’s capital target, measured as a percentage of both the basis for calculation and the leverage ratio
- The main features of the recovery plan of relevance to the institution's capital planning, with particular emphasis on the institution’s overall recovery capacity.

# Specifics on the ILAAP

The ILAAP shall include information on:

- the board's risk tolerance for liquidity and funding risk
- all material risk related to liquidity and funding for the institution and the group
- benchmarks, limits and/or threshold values for relevant indicators for liquidity and funding risk in the short (including intraday/daily liquidity balancing) and long term
- actual liquidity and funding situation measured by relevant indicators[6], including
  - the status or, for smaller entities, the estimated status of the total LCR at all consolidation levels at the end of each day (business days)
  - for institutions that are subject to Pillar 2 requirements for LCR in NOK: status of the LCR in NOK at all consolidation levels at the end of each day (business days)

[5] Institutions must document or substantiate the market values of significant positions, preferably in the form of a relatively new external valuation.

[6] The information shall be provided as graphs and cover the last calendar year (possibly up to the date of the ILAAP if it deviates from the year-end date), as well as as figures as at the reference date for the ILAAP.

  - for institutions that are subject to Pillar 2 requirements for LCR in currencies other than NOK: status of the LCR in the relevant currency at the end of each month (or more frequently)
  - for large institutions: status of the NSFR at the end of each month (or more frequently)
- factors that may challenge the board's risk tolerance in the long term
- an account of how the institution's operations are organised and controlled
- the institution's contingency plan for liquidity (brief description)
- the composition of the institution's liquidity buffer(s), including a specification of each security or the portfolio's maturity structure, LCR approval, rating, eligibility under the guidelines for pledging collateral for loans from Norges Bank or the equivalent in other central banks[7]
- composition and long-term developments in the institution's sources of funding – providing details on
  - deposits within the guarantee fund limit as a share of total deposits
  - the ten largest deposits from non-financial counterparties as a share of total deposits
  - the ten largest deposits from financial counterparties as a share of total deposits
  - share of deposits via online deposit platforms in Norway and abroad
- composition of the institution's sources of funding – other than deposits:
  - details on market funding (currency, amount, interest rate terms, maturity and instrument (senior bond debt, subordinated loans, etc.)), including long-term developments
    - the institution's (most important) external drawing facilities and settlement accounts
  - the limits or policy established by the board for the transfer of loans secured on real estate to covered-bond-issuing entities[8]. The actual transfer rate and long-term developments (at least over the last five-year period).
  - The value of loans secured on real estate that can be transferred to covered-bond-issuing entities relatively soon, as well as any requirements set by the covered-bond-issuing entity for reserves ready for transfer.
- the institution's latest forecast for liquidity developments, specifying key items and assumptions. For large institutions in particular, this will also apply to intraday transactions
- results of the latest stress tests, including a brief description/analysis
- description of the underlying assumptions for the stress test(s)
- the institution's survival horizon with and without stress
- the significance of ESG risks for the institution’s current status and future liquidity and funding challenges, such as
  - the institution's policy to include green bonds in its liquidity buffer investments
  - the institution's policy to issue green bonds itself and/or contribute to the issuance of green bonds by its wholly and/or partly owned covered-bond-issuing entities
  - the institution's ESG risk rating, if any (as an issuer of green bonds)

## Specifics on capital needs in a forward-looking perspective

The institution must specify its capital need in the short and long term.[9] Finanstilsynet expects institutions to adapt both their capital target and their actual level of capital to ensure an ample margin to the sum total of the minimum requirement under Pillar 1 and Pillar 2 and the buffer requirements. When determining the Pillar 2 guidance, Finanstilsynet expects the board to make an assessment of all significant risk factors that

[7] Finanstilsynet recommends that covered bonds based on a cover pool consisting of loans secured on real estate in Norway should account for maximum 50 per cent of the liquid assets in the LCR. (Total covered bonds may represent up to 70 per cent.)
[8] The institution's definition of the transfer rate if it differs from that set by Finanstilsynet. Finanstilsynet's definition is ‘loans secured on real estate transferred to and recorded in covered-bond-issuing entities as a share of the bank's total loans secured on real estate plus loans already transferred to and recorded in the covered-bond-issuing entity’.
[9] Financial Institutions Act, section 13-6 subsection (3)

may affect the institution's financial performance or capital situation. The board should give due weight to the need for adequate flexibility to be able to maintain normal lending activity during downturns and for the capitalisation to support access to capital markets also under difficult market conditions.

In this connection, institutions shall conduct stress tests that incorporate all material risks to which the institution is, or might become, exposed. The stress tests cannot be based on the assumption that the authorities will initiate remedial measures during the stress period. See the EBA's guidelines for stress testing for more information about requirements for the institution's own stress tests.[10] The stress tests shall reflect a very severe, but not unlikely, scenario spanning a period of at least three years. The institution must specify which assumptions in models and calculation methods have the greatest impact on its need for capital and show how important key figures develop during the stress period, e.g. the CET1 ratio, the leverage ratio and the institution's liquidity and funding situation. In particular, the institution shall assess how changes in exchange rates may cause volatility in the institution's future capital situation. If the stress test results in the institution breaching one or more of the institution's recovery indicators, this must be specified.

The ICAAP shall document how stress testing is employed in the institution's capital planning. As part of the stress test, the institution may document relevant measures that can help reduce negative effects. However, the result of the stress test should be assessed and shown, both with and without such measures.

Finanstilsynet would like to point out that institutions should assess climate risk as part of their stress tests.

As part of its assessment of capital needs in a forward-looking perspective, Finanstilsynet expects the institution to report on the effect of new capital requirement calculations resulting from updates of the CRR and CRD.

## Reporting of ICAAP and ILAAP

All institutions encompassed by the guidance on Finanstilsynet's practices for assessing risk and capital needs must report ICAAP and ILAAP annually. The institution shall prepare ICAAP and ILAAP documents on the basis of the situation at the end of the year. When the institution has revised its ICAAP and ILAAP and the board has given its approval, the institution shall, as soon as possible, send the documentation and appendices thereto to Finanstilsynet, preferably by 30 April. The institution shall use Altinn form KRT-1172 and provide all figures at the highest consolidation level.[11]

[10] EBA/GL/2018/04 Guidelines on institutions' stress testing

[11] Both the numerator and the denominator in capital adequacy calculations must be specified at the highest level of consolidation and in NOK 1 000.

# Appendix 2: ASSESSMENT OF PILLAR 2 CAPITAL NEEDS FOR CREDIT RISK

This appendix describes the methods used to support the assessment of the institution's capital need for credit risk under Pillar 2, including credit-related concentration risk.

Finanstilsynet's assessment of capital needs for credit risk under Pillar 2 is supported by a calculation method assuming persistently high lending growth and unused credit lines with a 0 per cent conversion factor.

For concentration risk, Finanstilsynet uses a calculation method for assessing capital needs under Pillar 2 for single name concentration (corporate market) and sector concentration.

## Persistently high lending growth

Growth in lending entails an increased need for capital under Pillar 1 as loans are included in the institutions' balance sheets. However, the Pillar 1 capital requirements do not capture the higher risk of losses resulting from negative selection when the institution's lending growth is higher than market growth over time. Finanstilsynet has therefore established a method that captures the risk associated with institution-specific lending growth. The method distinguishes between loans to personal borrowers (pm) and loans to corporate borrowers (bm). Loans in both wholly and partly owned subsidiaries (cf. residential mortgage companies) are included, and Pillar 2 add-ons are calculated on a consolidated basis.[1] Loans to municipalities (local government administration) and financial institutions are not included. The method is based on the assumption that institutions with average lending growth over two years[2] (annualised geometric average) of more than 6 per cent will have an increased need for capital under Pillar 2 related to high lending growth. The level at which the Pillar 2 add-on for high lending growth is triggered is based on historical credit growth.

$$\boldsymbol{K_{Vpm} = Max\left[E_{pm}\left(1 - e^{2(0.06 - V_{pm})}\right)0.02\ ;\ 0\right]}$$

$$\boldsymbol{K_{Vbm} = Max\left[E_{bm}\left(1 - e^{2(0.06 - V_{bm})}\right)0.05\ ;\ 0\right]}$$

$$\boldsymbol{V = \left(\frac{E_t}{E_{t-2}}\right)^{0,5} - 1}$$

$K_{Vpm}$ = capital need for lending growth, household portfolio
$K_{Vbm}$ = capital need for lending growth, corporate portfolio
E = total loan portfolio (drawn down loans – reported to ORBOF/FINREP)
V = lending growth over two years – annualised (geometric average)

The method can estimate capital needs related to the household portfolio and the corporate portfolio of maximum 2 per cent and 5 per cent, respectively, of the loan portfolio.

[1] No capital needs under Pillar 2 are assumed for lending growth in wholly and partly owned mortgage companies.
[2] For institutions reporting FINREP, the data sources are F18.00 [c010r150+c010r197+c010r227] (PM) and F06.01 (BM). For other institutions, the data source is ORBOF. (PM is defined as sector codes 85000 and 98000.)

Finanstilsynet also makes a discretionary assessment of the estimate. For example, the method does not distinguish between organic growth and growth achieved through acquisitions and mergers. Nor does the method factor in overall growth in the institution's portfolio or risk arising from high growth and increased exposure outside the institution's defined core geographical area.

Partly owned covered-bond-issuing entities shall not need additional capital to cover lending growth as such growth is taken into account in assessments of the individual parent bank.

## Undrawn credit lines with a 0 per cent conversion factor

The method is primarily intended to cover undrawn credit card facilities with a conversion factor of 0 per cent. In many cases, such facilities will be categorised as retail exposures.

The capital need for undrawn credit lines with a conversion factor (Ku) of 0 per cent is calculated using the following formula:

$$Ku = E * 0.1 * 0.75 * 0.125$$

E = Exposure with a 0 per cent conversion factor
Conversion factor = 10 per cent
Risk weight = 75 per cent
Capital add-on = 12.5 per cent

** based on line 010, column 160 of COREP reporting form C 07.00, 008 'institutions", 009 'retail exposures',*
*010 'Exposures secured on property' and 017 'Other exposures'.*

In Finanstilsynet's opinion, the chosen factors in the method entail, overall, a moderate need for capital for the risk associated with undrawn credit lines.

## Single name concentration (corporate market)

The method is based on the use of the Herfindal-Hirschman index (HHI)[3] to measure concentration and uses grouped counterparties from the exposure reporting (KRT-1115).

$$K_e = E_{BM}(1 - e^{-10*HHI_e})0.1$$

$$HHI_e = \sum_{i=1}^{n} s_i^2 \qquad s_i = \frac{E_i}{\sum_{i=1}^{n} E_i} \qquad E_{BM} = \sum_{i=1}^{n} E_i$$

**Ke** = capital need for single name concentration
**Ei** denotes the institution's exposure to entityi
$\mathbf{E_{BM}}$ is the overall corporate market exposure

In the case of groups the calculations are made at consolidated level. Hence, loan exposures to subsidiaries

[3] The simplified method can be applied to all institutions that report data on corporate exposures at the end of the year. Finanstilsynet's calculations are based on Gordy and Lütkebohmert's method.

are not included in the calculations whereas corporate exposures of subsidiaries (for example wholly-owned commercial mortgage companies) to external clients are included. Loan exposures to joint venture entities that are not incorporated in the consolidated accounts are also included. However, exposures to financial institutions and housing cooperatives are excluded from the calculations. Because the HHI is a convex function at ever higher portfolio concentrations, the capital need based on this method will in many cases be lower where a well-diversified sub-portfolio is included in the calculation, for example a retail portfolio. The data used in Finanstilsynet's assessment are from the exposure reporting KRT-1115.

## Sector concentration

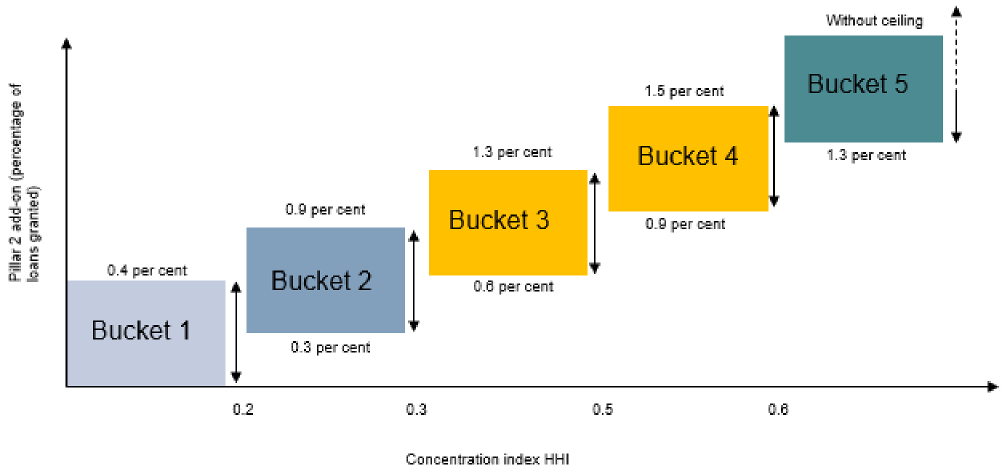
Finanstilsynet's method aims to capture increased capital needs related to sector concentration risk.[4,5]

The calculation of capital add-ons for sector concentration is based on the standard formula for HHI:

$$\boldsymbol{HHI = \sum_{i=1}^{n} w_i^2}$$

Where $w_i$ denotes the exposure to sector *i*.

The index will range from 0 to 1, where 1 indicates that the entire portfolio is invested in one sector. The calculation is based on 22 sectors. Finanstilsynet places institutions in different buckets based on the concentration index:




[4] Classification into 22 sectors

To support the determination of capital add-ons for sector concentration, Finanstilsynet uses the following formula:

$$\boldsymbol{\rho = 12,5(1\text{-}e^{-5 \times HHI^{1,5}})}$$

ρ in the above formula provides a maximum capital requirement for sector concentration in per cent of loans granted. ρ is multiplied by 12.5 per cent of loans granted. Finanstilsynet may set higher or lower capital add-ons for sector concentration, cf. the above-mentioned division into buckets.

The systemic risk buffer addresses systemic risk related to Norwegian financial institutions, including total concentration in property-related sectors. In Finanstilsynet’s assessment, loan portfolios with a sector concentration below 0.15 (HHI) can be considered to be sufficiently diversified. In principle, there is no need to set a Pillar 2 add-on for sector concentration in such cases.

For portfolios with an estimated HHI index > = 0.15, the capital add-on for sector concentration will be based on an overall assessment of the mathematical calculation, using the above formula as well as a discretionary assessment. The institution will generally be asked to include a capital add-on within the bucket to which the institution belongs, cf. the table above.

Exposures to financial sector entities and housing cooperatives shall not be included in the calculation of capital add-ons for sector concentration.

# Appendix 3: ASSESSMENT OF INSTITUTION-SPECIFIC CAPITAL NEEDS FOR MARKET RISK

Finanstilsynet carries out a supervisory review and evaluation process (SREP) on the basis of the institution's ICAAP and includes risks and capital needs that are not covered, or are only partially covered, by the general capital requirements.

When Finanstilsynet considers that the institution's assessed capital need in the ICAAP does not sufficiently cover the assessed risk, Finanstilsynet will use its own calculation methods to support its assessments of the institution's overall capital need. The calculation methods estimate the loss potential for relevant exposures by stress testing various risk factors. In addition, qualitative assessments are made of portfolio concentration and liquidity, and of risk management and control.

## Market risk not covered by the general capital requirements

The EBA's SREP guidelines[1] require supervisory authorities at minimum to evaluate market risk in the trading book, as well as interest rate risk, credit spread risk and equity risk in the banking book.

Under the general capital requirements, equity and interest rate risk in the trading book, as well as currency and commodity risk, are included in the overall portfolio. For equities and fixed-income securities in the banking book, there are no general capital requirements for market risk but a capital requirement for credit risk. There are no general capital requirements for interest rate risk and credit spread risk in the banking book. In the assessment of institution-specific capital needs for market risk in the banking book, general capital requirements will be taken into account unless otherwise specified. Table 1 shows the risks covered by general capital requirements (Pillar 1) and the risks included by Finanstilsynet in its assessments of institution-specific capital needs (Pillar 2).

**Table 1: Risk factors under Pillar 1 and Pillar 2**

| Pillar 1 | Pillar 2 |
|---|---|
| • General interest rate risk in the trading book | • General interest rate risk in the banking book (IRRBB) |
| • Specific interest rate risk (credit spread risk) in the trading book | • Specific interest rate risk (credit spread risk) in the banking book (CSRBB) |
| • General equity risk in the trading book | • General equity risk in the banking book |
| • Specific equity risk in the trading book | • Property risk in the banking book |
| • Currency risk in the overall portfolio | • Currency and commodity risk in the overall portfolio |
| • Commodity risk in the overall portfolio | • Basis spread risk |
| • CVA risk | |
| • AVA | |
| | • Liquidity and concentration (qualitative assessments) |
| | • Management and control (qualitative assessments) |

Risks in trading book activities that are not adequately covered by the general capital requirements (e.g. due to complex products, non-liquid positions, etc.) will be taken into account in Finanstilsynet’s assessment of the need for institution-specific capital requirements. In this context, this also entails making a qualitative assessment of position concentration and market liquidity, and of the bank's management and control of market risk.

[1] EBA/GL/2022/03

The following describes the methods on which Finanstilsynet bases its assessments of the capital need for market risk in the banking book when the capital need assessed by the institution is deemed to be insufficient. The methods are based on the estimated loss potential for relevant exposures in the event of sudden changes in key market risk factors. Assessments are made of the loss potential for equity risk, interest rate risk, currency risk, credit spread risk and property risk. The overall loss potential represents the institution-specific capital requirement, which is calculated by summarising the loss potential for each of the risk categories, including any qualitative add-ons.

## Risk-weighted assets

The general capital requirements are set with a basis in actual positions. As a rule, Finanstilsynet will also use actual positions as a basis for assessing the institution-specific capital need. If Finanstilsynet concludes that the actual positions on which the institution has based its assessments are not representative of the institution's normal exposure during the year, the basis may be adjusted.

## Equity risk

Finanstilsynet will make an overall assessment of the institution's portfolio to determine whether circumstances exist to justify an institution-specific need for capital in excess of the need for capital assessed by the institution itself. Finanstilsynet's assessment of institution-specific capital needs is based on the assumption that there will be a 45 per cent decline in equity prices for actual positions that are not strategic and related to ordinary banking operations. The capital requirement under Pillar 1 is deducted from the estimated loss potential.

## Property risk

Many financial institutions have direct ownership in properties or property companies on their banking book. Properties in the banking book are often repossessed as a result of defaulted credit exposures. Finanstilsynet calibrates a stress factor of 30 per cent for property. The capital requirement under Pillar 1 is deducted from the estimated loss potential.

Loss potentials are calculated on the basis of the market value of actual holdings on the date of assessment. Property exposure that is part of the basis for calculation includes positions and participations in commercial property, property companies, property funds as well as direct ownership of property, including a bank's own buildings and property for own use or for the use of employees. With respect to properties that are not carried at fair value, any excess values will be subject to a discretionary assessment if it can be documented that their book value is substantially lower than fair (market) value.

## Interest rate risk

In accordance with the CRD, the EBA has developed guidelines for IRRBB[2]. The European Commission has adopted a supplementary regulation specifying supervisory shock scenarios and common modelling and parametric assumptions (Regulation (EU) 2024/856)[3] and a regulation specifying a standardised methodology and a simplified standardised methodology for assessing IRRBB (Regulation (EU) 2024/857).[4] Both regulations have been implemented in Norwegian law.

[2] Guidelines on IRRBB and CSRBB
[3] CRR/CRD Regulations, section 2 no. 80
[4] CRR/CRD Regulations, section 2 no. 81

The EBA's guidelines on IRRBB specify criteria for the identification, monitoring and management of IRRBB, as well as for the evaluation of internal measurement systems. Finanstilsynet expects the institutions to comply with the guidelines.[5]

When assessing IRRBB and associated capital needs, Finanstilsynet places emphasis on both the capital need assessed by the institution and its reported exposure. Finanstilsynet also takes the institution's balance sheet, risk limits and business model into consideration, as well as the quality of the systems and models used in managing operations. Comparisons will also be made for groups of institutions, so that significant distinctions resulting from differences in modelling assumptions and management and control can be taken into account.

The institutions themselves must calculate the effect of the six different interest rate shock scenarios on the economic value of equity (EVE). Part A of Regulation (EU) 2024/856 specifies shock scenarios for different currencies, but not for the Norwegian krone (NOK). The effect of the interest rate shock to be used for NOK is 200 bp for parallel interest rate shifts, 300 bp for short-term interest rates (up to two years) and 150 bp for long-term interest rates (from seven years and longer).

Institutions must also assess how changes in interest rate levels, i.e. parallel shifts up and down, may affect the net interest income (NII method) over a period of one year. Institutions in SREP categories 1 and 2 are also expected to prepare interest rate shocks adapted to the institution's business model. The shock should be a possible but unlikely macro stress.

# Credit spread risk

The EBA's guidelines on IRRBB and CSRBB6 specify criteria for the identification, monitoring and management of CSRBB. In accordance with the EBA's guidelines, Finanstilsynet will evaluate the institution's self-assessments of credit spread risk based on internal measurement systems. If Finanstilsynet considers the institution's internal processes for the identification, monitoring and measurement of credit spread risk to be insufficient, the method outlined below will be used.

The method used to assess institution-specific capital needs for credit spread risk builds on the methodology of Solvency II for insurance undertakings. A loss potential is calculated as a function of rating level and duration, see table 2 below. The stress factors are calibrated based on historical data for actively traded corporate bonds denominated in euro. There is an insufficient basis for a calibration based specifically on Norwegian data. The estimated loss potential is multiplied by a factor of 0.6, and the result constitutes Finanstilsynet's basis for assessing institution-specific capital needs for credit spread risk. When using this method, no deduction is calculated for the general capital requirement.

[5] Article 16 (3) of Regulation (EU) No 1093/2010 incorporated into the EEA Agreement Annex IX Financial Services no. 31g
[6] EBA/GL/2022/14

**Table 2: Spread risk, link between rating and assumed spread change**

| Rating[7] | Risk category | Change in spread |
|---|---|---|
| AAA | 1 | 0.9% |
| AA | 1 | 1.1% |
| A | 2 | 1.4% |
| BBB | 3 | 2.5% |
| BB | 4 | 4.5% |
| B | 5 | 7.5% |
| Lower than B | 6 | 7.5% |
| Not rated (minimum duration of 1 in the calculation) | - | 3.0% |
| '0 weightings' excluding government bonds with AA and AAA ratings | - | 0.3% |
| Covered bonds (AAA) | 1 | 0.7% |
| Covered bonds (AA) | 1 | 0.9% |

The actual portfolio of interest-bearing securities in the banking book is used as the basis for calculation. Market values on the assessment date shall be used in the calculation. According to the EBA's guidelines on IRRBB and CSRBB, no instruments in the banking book should be excluded from (the scope of) the CSRBB, regardless of their accounting treatment. Instruments that are not sensitive to credit spread risk may be excluded based on an assessment that should be well documented and duly justified. Instruments that are carried at fair value should under no circumstances be excluded. See also the EBA's guidelines on IRRBB and CSRBB.

Positions in covered bonds issued by wholly or partly owned mortgage companies are excluded ('own' covered bond holdings). Reference is made to the market risk module.[8] Finanstilsynet will make discretionary assessments, inter alia in situations where the institution has large holdings of covered bonds issued by wholly or partly owned mortgage companies. See the paragraph below on qualitative assessments of the portfolio's liquidity and concentration.

Government bonds issued by OECD states (in their own currency) with ratings equivalent to minimum AA- are not included in the calculation. For other issuers with a 0 per cent risk weight according to Articles 114, 115, 117 and 118 of the CRR, a 0,3 per cent change in the spread is assumed.[9] This applies to institutions in EU member states where the authorities have recognised 0 per cent risk weighting of the bonds. Any short positions in corresponding instruments issued by the same issuer are deductible.

As a simplification, use is made of the average residual maturity for the portfolio in each rating grade in the calculation. Positions in fixed-income funds shall be included in the basis for calculation. Where the average duration and rating of the fund are not specified, a maturity of three years will be utilised, and it will be assumed that the holding is not rated. Finanstilsynet's method does not cover spread risk related to the institutions' own borrowings.

In its ICAAP, the institution should specify the rating used, as well as sources. In the CRR, only ratings by export credit agencies are accepted, cf. CRR Articles 137-141.

[7] Standard & Poor's rating grades are included in the table as an illustration.
[8] Market risk module (in Norwegian only)
[9] The level is based on observed changes in spreads in 2020 relative to covered bonds.

## Currency risk

Finanstilsynet employs a stress factor of a 25 per cent change in exchange rates in its assessment of currency risk. The general capital requirement for currency risk applies only if the institution's aggregate net foreign currency position exceeds 2 per cent of own funds. Net currency risk is based on the higher of, respectively, the sum of short and the sum of long positions across all currencies. The basis for calculation for Finanstilsynet's stress test in the assessment of the institution-specific need for capital is the institution's aggregate net position in foreign currency, calculated according to Article 352 of the CRR, less 2 per cent of own funds.

## Basis spread risk

A number of large institutions, mainly in categories 1 and 2, finance large parts of their operations in foreign markets and therefore hold significant positions in basis swaps. In the wake of the financial crisis, there have periodically been major changes in the pricing of basis swaps. Due to the fact that the secured instrument (funding) is not exposed to these changes in value, the changes in the value of the derivatives pose a risk for the institutions. Finanstilsynet assumes that institutions with large positions in basis swaps assess the need for capital for this risk.

## Qualitative assessment of portfolios' concentration and liquidity

A qualitative assessment of exposures' concentration and market liquidity will be conducted. See further details in the module for market risk. Following a qualitative assessment of the portfolios, an add-on is assigned to the loss potential for the exposures' concentration and liquidity for each risk factor of 0 per cent (low risk), 10 per cent (moderate risk) or 20 per cent (considerable risk). The maximum overall qualitative add-on to the loss potential for a given risk factor is accordingly 40 per cent. In general, portfolios considered to have a 'satisfactory' risk profile will not be assigned an add-on to their loss potential.

# Appendix 4: ASSESSMENT OF CAPITAL NEEDS UNDER PILLAR 2 RELATED TO OWNERSHIP IN INSURANCE UNDERTAKINGS

This appendix describes Finanstilsynet's method for assessing capital needs under Pillar 2 related to ownership risk and institutions' ownership in wholly and partly owned insurance undertakings. Finanstilsynet emphasises that the ownership and the associated risks represent more than a mere share investment and are thus assessed to represent strategic ownership risk.

The method is based on the insurance undertaking's solvency capital requirement (SCR). Solvency capital is an element in the assessment of capital needs after adjusting for the valuation of the holding (adjustment for book value). There should be consistency between the two with regard to the handling of planned dividend payments. According to the method, an adjustment is made for the book value of the holding and other paid-in capital. Finanstilsynet uses the book value from the consolidated financial statements for banks reporting capital adequacy at a consolidated level, and the book value for the parent bank for banks that report capital adequacy at an unconsolidated level. In cases where ownership of the insurance undertaking is indirect, Finanstilsynet considers making an adjustment for other assets and liabilities in the balance sheet of the intermediate undertaking. According to this method, the solvency capital requirement is multiplied by a factor allowing for the fact that the actual capital adequacy ratio will normally be higher than the solvency capital requirement. Finanstilsynet has chosen not to use this factor, which means that the actual capital requirement is included in the calculation.[1]

When assessing the capital need related to ownership in insurance undertakings, an adjustment is made for capital requirements calculated under Pillar 1. The Pillar 1 rules entail that the book value of the holding is included in the basis for calculation within a certain quota (known in Norway as the 'free quota), cf. the Capital Requirements Regulation (CRR) Articles 46 and 48, while the excess amount is deducted from the parent banks' capital.[2] Please note that several investments may be included in the free quota. With respect to any paid-in own funds, the Pillar 1 charge is taken into account by risk weighting the basis for calculation and/or capital deductions.

In summary, the method of assessing capital under Pillar 2 is as follows:

$$\textbf{Capital need}_{\text{total}} = [\textbf{solvency capital requirement * factor – solvency capital}] \textbf{ * Ownership share + BV}$$

$$\textbf{Capital need}_{\text{Pillar 2}} = \textbf{Capital need}_{\text{total}} – \textbf{Capital need}_{\text{Pillar 1}}$$

BV = book value of the holding and other paid-in capital
Solvency capital = eligible SCR capital

[1] The factor is thus set at 100 per cent.
[2] Please note that goodwill included in the valuation of unconsolidated financial sector entities (significant investments) cannot be included in the free quota but must be deducted from common equity Tier 1 capital, cf. Article 37 of the CRR.

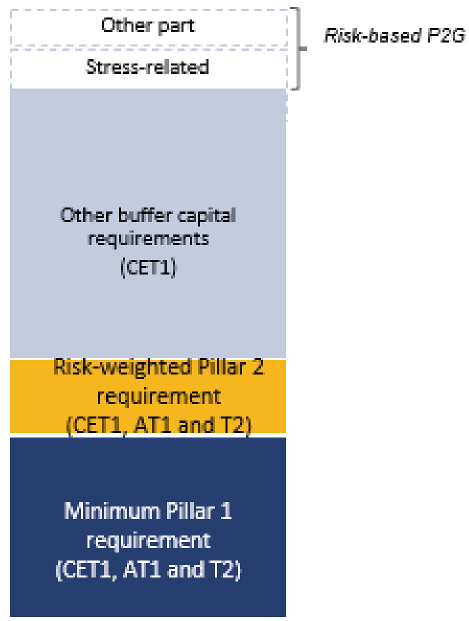
# Appendix 5: PILLAR 2 GUIDANCE (P2G)

The Pillar 2 guidance is determined in accordance with the CRR/CRD Regulations, section 47. Institutions are required to set capital targets which ensure that the level of own funds is appropriate to the risks to which the institution is exposed and covers the losses the institution may be exposed to in a stress situation, including the losses resulting from the supervisory authority's stress tests. The supervisory authority shall regularly assess the institution's capital targets as part of the SREP and take into account the assessment of internal models and the results of the institution's stress test, cf. CRD Article 104b no. 2. The Pillar 2 guidance shall be institution-specific and may address the same risks and risk elements that are included in the Pillar 2 requirement but only if the risk is not already considered to be covered through the Pillar 2 requirement, cf. CRD Article 104b no. 4.

A financial institution shall in its overall capital assessment in the ICAAP state its need for capital in the short and long-term and assess how this capital need can be met. The institution must therefore prepare a capital plan as part of its ICAAP documentation. Finanstilsynet expects institutions to adapt both their capital target and actual level of capital to ensure an ample margin to the overall capital requirement, consisting of the sum total of the minimum requirements under Pillar 1 and Pillar 2 and the buffer requirements. When determining the institution's capital target, the board of directors of the particular institution should attach importance to the institution's business model, its room for manoeuvre in a forward-looking perspective, its ability to maintain normal lending growth, and the need for capitalisation to support access to capital markets also under difficult market conditions.

Finanstilsynet will, on the basis of the institution's assessment and its own assessments, communicate an expectation regarding the Pillar 2 guidance. Finanstilsynet's expectation concerning the Pillar 2 guidance is based on an individual assessment of each institution and is communicated to the institution along with the decision on the institution's increased capital requirement. The P2G shall consist of CET1 capital. Chart 3 illustrates capital requirements and the Pillar 2 guidance.

Chart 1: Illustration of capital requirements and the Pillar 2 guidance




As a rule, Finanstilsynet uses stress tests to assess the level of own funds the institution is expected to hold in excess of its capital requirement. In cases where stress tests cannot be applied, sensitivity analyses etc. can also be used.[1]

Based on the results of Finanstilsynet's stress tests or sensitivity analyses, institutions are placed in different buckets as indicated below. Each bucket represents a lower and upper reference point that provides a basis for assessing the level of the institution's P2G. The buckets overlap and reflect that only institution-specific factors that are not covered by the stress test can be taken into account. In its assessment, Finanstilsynet will consider stress test results over time, as well as the institution's characteristics and risk profile, the institution's own stress test framework and other stress test results. See separate section on stress tests below.

[1] EBA/GL/2022/03, section 426.

The following buckets are used as the basis for Finanstilsynet's P2G decision:

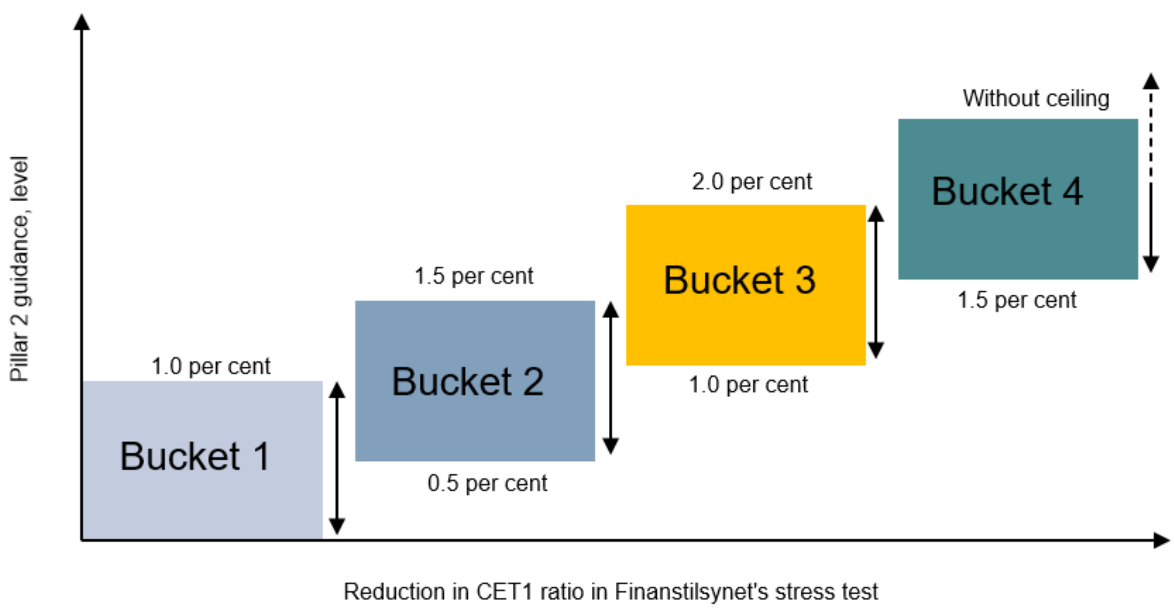
Bucket 1: The expected P2G represents up to 1.0 per cent of risk-weighted assets.

Bucket 2: The expected P2G represents between 0.5 per cent and 1.5 per cent of risk-weighted assets.

Bucket 3: The expected P2G represents between 1.0 per cent and 2.0 per cent of risk-weighted assets.

Bucket 4: The expected P2G represents minimum 1.5 per cent of risk-weighted assets.

Chart 2: Buckets for expected P2G




In extraordinary cases, Finanstilsynet may communicate a P2G level outside the relevant bucket.

## Use of stress tests in assessments of expected P2G

When assessing the level of the P2G for individual institutions, Finanstilsynet takes account of the institution's own stress tests and Finanstilsynet's stress tests. If relevant, Finanstilsynet also takes other stress tests into consideration, for example stress tests conducted by the EBA and the IMF. Finanstilsynet also uses the various stress tests in its assessment of the P2G-LR.

Among other things, Finanstilsynet assesses the assumptions on which the institution's own stress tests are based, and whether the assumptions are based on sufficiently long time series to cover previous relevant crises. With respect to Norwegian banks' credit activities, this will in practice mean data series covering the banking crisis in the early 1990s. Finanstilsynet also assesses the results of the bank's various stress scenarios and compares these with the results of

Finanstilsynet's own stress tests. If the institution expects to implement risk-mitigating measures or communicates this in its own stress tests, Finanstilsynet assesses whether the measures seem relevant and whether they are possible to implement during the stress period. Finanstilsynet also considers whether the institution's stress tests are adequate to reveal weaknesses in the business model. When assessing stress tests and stress test results, Finanstilsynet may also take the institution's recovery plan and the assessment of the institution's recovery capacity into consideration.

Finanstilsynet uses a separate stress test to assess developments in the institution's profits and capitalisation under the assumption of severe stress in the Norwegian economy. Finanstilsynet's calibration of the stress test assumptions is based on projections in Finanstilsynet's macro model, NAM-FT[2]. This ensures consistency between Finanstilsynet's assessments of systemic risk and the effects of a steep recession at macro level, and the impact on the individual institution's financial performance, balance sheet and capital adequacy. Finanstilsynet's solvency stress test covers most Norwegian banks, as well as mortgage companies. The stress tests are prepared annually and are based on macro stress scenarios using detailed micro information, such as specific information about virtually all of the banks' loan exposures and the probability of default for non-financial corporations. The stress tests cover credit risk, uncertainty attending developments in net interest income, market risk[3] and behavioural/operational risks, as well as other elements that may affect the institution's earnings. The stress tests are adapted to the institutions' existing business models, which primarily include lending to personal and corporate customers as well as some market activity and cover a 4-5 year projection period.

Finanstilsynet assesses, on a discretionary basis, whether the stress tests are well suited for the individual bank's business model and stress testing framework. If Finanstilsynet's stress test is not suitable for the institution, Finanstilsynet may base its assessment on various sensitivity analyses when assessing the expected P2G. Finanstilsynet may also take account of other factors that may cause variations in the bank's CET1 capital ratio.

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[2] See description of Finanstilsynet's stress tests in Risk Outlook

[3] The largest banks report their securities exposure to Finanstilsynet in connection with Finanstilsynet's overall risk assessment