FINANSTILSYNET
THE FINANCIAL SUPERVISORY AUTHORITY OF NORWAY

Circular

Finanstilsynet's practices for assessing risk and capital needs

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Contents

1 Introduction

This circular and appendices describe the main elements of Finanstilsynet's assessment of institutions' overall risk level and need for capital (SREP[1]), including Finanstilsynet's methodology for assessing capital needs under Pillar 2. The circular must be viewed in the context of the European Banking Authority's (EBA) SREP guidelines and the determination of capital needs under Pillar 2.[2] This circular replaces circular 12/2016.

Chapter 2 provides an overview of the various elements included in the SREP and how these are interconnected. Chapter 3 describes the division of institutions into categories that determines the frequency and scope of Finanstilsynet's SREP assessment and dialogue with individual institutions. Chapter 4 describes Finanstilsynet's ongoing monitoring of institutions' risk level and risk developments. Chapter 5 provides an overview of important assessment criteria and elements included in Finanstilsynet's analysis of institutions' business model, as well as business and strategic risk. Chapter 6 provides an overview of the key criteria emphasised by Finanstilsynet when assessing institutions' internal governance. Chapter 7 describes Finanstilsynet's assessment of institutions' various risk areas. Chapter 8 covers the assessment of institutions' level of capital and capital needs and describes the methodology used as a tool to support Finanstilsynet's assessment of institutions' need for capital under Pillar 2 for individual risks. The methodology is described in further detail in appendices 2-4. Chapter 9 provides an overview of the elements included in the overall
SREP assessment and relevant supervisory measures and tools, including requirements for corrective measures and orders. Chapter 10 describes SREP assessments of cross-border groups.

In addition to the methodology and assessment criteria discussed in this circular, 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.

[1] SREP – Supervisory review and evaluation process

[2] Directive 2013/36/ EU (CRD) art. 104 no.1 a and EBA/GL/2022/03

2 The SREP framework

Finanstilsynet's SREP framework, as described in this circular, is based on the EBA's guidelines for the SREP (EBA/GL/2022/03), cf. Article 97 of Directive 2013/36/EU (CRD).

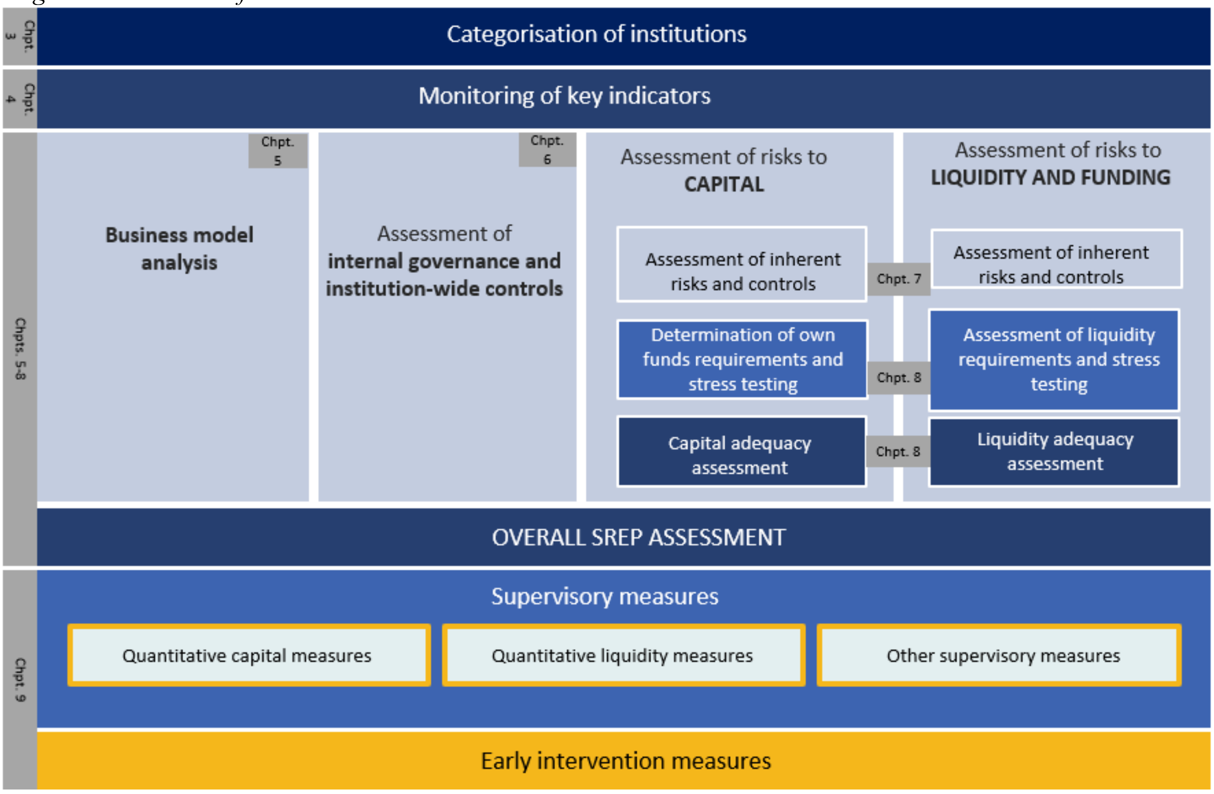
The framework for Finanstilsynet's SREP assessment, the elements and assessment criteria that are included and how the process is carried out are described below.

Elements 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 in light of this
- Assessment of risk related to the institution's liquidity and funding, as well as the institution's liquidity and funding needs

The above elements are summarised in an overall SREP assessment, where the need for supervisory measures is also assessed.

Figure 1: Overview of the various elements included in the SREP



About the SREP
Finanstilsynet summarises its assessment of the individual institution's risk and capital needs, including the need for capital under Pillar 2, in a letter sent to the institution's board of directors. The board is given the opportunity to comment on the assessment of the need for capital under Pillar 2 within a set deadline. After Finanstilsynet has received the board's comments, a final assessment of the institution's risk and capital needs (overall SREP review) is made, and Finanstilsynet determines the institution's Pillar 2 requirement. Finanstilsynet's decision on Pillar 2 requirements has a legal basis in the Financial Supervision Act, section 4 and the Financial Institutions Act, section 13-6 subsection (7).[3]

A letter to the institution is prepared, summarising and explaining Finanstilsynet's final SREP assessment.[4] Finanstilsynet's decision on the Pillar 2 requirement is sent to the institution and published on Finanstilsynet's website.

Finanstilsynet's decision may be appealed within three weeks after the institution has received the decision. Any complaints must be sent to Finanstilsynet.[5] The decision on the Pillar 2 requirement applies until a new decision has been made.

In its letter, Finanstilsynet also expresses an expectation as to the institution's Pillar 2 guidance (P2G).[6]

Finanstilsynet may, through its SREP feedback or in some other way, express its expectations concerning improvements or issue orders for improvements.[7] In some cases, Finanstilsynet will lay down temporary Pillar 2 requirements.[8] This is particularly relevant when other supervisory measures are considered insufficient or inappropriate. Finanstilsynet may also make decisions on temporary Pillar 2 requirements outside the ordinary SREP, cf. chapter 3. It is particularly relevant to lay down temporary Pillar 2 requirements for risk related to the institution's business model (chapter 5), internal governance (chapter 6), weaknesses in internal models (chapter 7.1) and compliance with the anti-money laundering (AML) legislation (chapter 7.3).

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 the Pillar 2 requirement will be set at consolidated level for the institution in question. When the Pillar 2 requirement also applies at solo level, this will be specified in the decision.[9]

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[3] Cf. CRD Article 104a

[4] Cf. CRD Article 97

[5] The appeal authority is the Ministry of Finance

[6] Cf. CRD Article 104b no. 2

[7] Cf. CRD Article 104a no. 1b, cf. Articles 73 and 74 and CRR Article 393. See also chapter 9 on supervisory measures

[8] Cf. EBA/GL/2022/03 nos. 386, 387 and 549

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

3 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. The division into SREP categories will primarily be adapted to the categorisation of institutions according to CRR 2 Art. 4 nos. 145 and 146.

Category 1 will include systemically important institutions.[10] As a rule, medium-sized and large institutions that are not included in category 1 are included in SREP category 2. Small and less complex institutions where there is no regular dialogue with the board of directors and management shall, as a rule, be included in SREP category 4. Other small and medium-sized institutions may be included in SREP category 3. When determining which category the institutions belong to, Finanstilsynet considers the institution's business model and type of business, as well as risk exposure. Finanstilsynet also takes other factors into account, such as whether the institution is newly established or has undergone structural changes (merger etc.).

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.

Table 2 summarises the categories of institutions, as well as the frequency and scope of SREP assessments and Finanstilsynet's dialogue with the institutions.

Table 2: Frequency and scope of SREP assessments and follow-up of the institutions

SREP – Finanstilsynet's follow-up of the institutions				
Category	Monitoring of key perform. 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 assessments may occasionally deviate from that shown in table 2. For example, there may be a need for a new SREP assessment 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

[10] Cf. CRR/CRD IV Regulations Part VIII.

etc.) that have resulted in a material change in the overall risk level. A new review will normally cover all risk areas.

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. The ICAAP and ILAAP shall be sent to Finanstilsynet, generally by 30 April[11] as an attachment to Altinn form KRT 1172. In its SREP assessment, 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 SREP assessment is based on the principle of proportionality. As a rule, Finanstilsynet's risk analyses 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 7 may be less relevant for some institutions. In other cases, a more thorough risk analysis may be required for small and less complex institutions, or institutions with a simple business model but a high risk exposure.

[11] Finanstilsynet will base its assessment of risk and capital needs on the most recent available ICAAP and ILAAP. As a rule, the assessment is carried out in the second and third quarter of the year.

4 Ongoing monitoring

Finanstilsynet regularly tracks selected risk indicators and financial key figures for individual institutions, including 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.[12]

5 Assessment of business model

As part of the SREP, Finanstilsynet assesses the institution's business model and overall strategy, including the business model's viability and sustainability in the short and long term. Finanstilsynet also assesses capital needs related to business and strategic risk, including 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.

Assessment of business model and business and strategic risk
Finanstilsynet makes a comprehensive assessment of the institution's business model[13], focusing on its weaknesses and vulnerabilities. For the largest institutions, the assessment includes:

- an overarching analysis of the business model and which areas should be subject to further consideration
- strategic, market and regulatory parameters
- 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.
- strategy and financial plans, including planned changes in the institution's business model, growth and entry into new products and markets. Finanstilsynet also assesses whether the institution has incorporated ESG risks in its business model and strategy.

The risk of money laundering and terrorist financing is included in Finanstilsynet's assessment of the institution's business model. Some institutions' business model and/or operations may entail an elevated 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 the institution's business model.

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

[13] EBA/GL/2022/03 chapter 4.

For other institutions, the assessment of the business model is less extensive.

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.

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.[14] 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.

As part of the SREP, Finanstilsynet assesses whether the institution has proven that its business model is viable in the short, medium and long term.[15]

6 Assessment of internal governance

SREP includes an assessment of the institution's internal governance.[16] The assessment is based on available documentation, including the institution's ICAAP, 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 guidelines, mechanisms and processes for governance and management, are well adapted to the institution's risk profile, size, business model and complexity, and whether they are in compliance with relevant legislation and best practice. Finanstilsynet also assesses whether the framework for risk management and internal control covers all relevant risks[17], and whether it is adequately documented and implemented and complied with throughout the institution/group. In addition to setting minimum requirements for guidelines and procedures for the various risk categories in compliance with section 36 of the CRR/CRD IV Regulations, Finanstilsynet assesses whether adequate and appropriate guidelines and procedures have been established to ensure that the institution complies with prevailing anti-money laundering and counter-terrorist financing requirements. Similarly, consideration will be given to whether adequate and appropriate guidelines 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.

[14] Equity price risk is assessed under market risk, cf. section 7.2

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

[16] See Finanstilsynet's module for internal governance (in Norwegian only)

[17] Cf. EBA/GL/2022/03 chapter 5

Finanstilsynet assesses the organisation of independent control functions and the resources and expertise assigned to the various functions. In addition, any weaknesses identified in the review of the institution's recovery plan are taken into account. The institution's remuneration schemes may also be reviewed as part of the SREP, as may its corporate and risk culture.

When assessing risk culture and behavioural factors, Finanstilsynet will, in addition to observing conduct, take the institution's internal guidelines into consideration, including codes of ethics and guidelines for identifying and handling conflicts of interest, as well as rules for loans to and other types of transactions entered into with members of the board of directors and management and their close associates.

As part of its assessment of the institution's risk management system, Finanstilsynet will consider its approved risk appetite and how it correlates to the institution's overall business and risk strategy, as well as its risk management framework.

The board shall ensure that the institution has documented guidelines for ICAAP and ILAAP, that it prepares an ICAAP and ILAAP document[18] at least annually, and that these documents function as important tools in the institution's risk identification and management process. The board is responsible for ensuring that the ICAAP and ILAAP and 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.

The board of directors shall ensure that the annual ICAAP and ILAAP documentation is evaluated by a body independent of the institution's administration, and that the independent evaluation is part of the basis for the board of directors' decisions with regard to the ICAAP and ILAAP. In Finanstilsynet’s opinion, it is important that the board implements a process to ensure that the institution has sufficient capital relative to its overall risk profile. Particular emphasis will be placed on assessing whether the board fulfils its role in ensuring compliance with the institution's strategy and guidelines.

As part of the SREP, Finanstilsynet may also take 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 evaluates the institutions' stress tests, the 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 institution's stress tests in ICAAP will also be considered against Finanstilsynet's own stress tests.

Finanstilsynet also takes account of the institution's own assessments of risk and capital needs related to internal governance.

[18] Cf. the Financial Institutions Act, section 8-6 and section 13-6 subsection (1)

7 Risk analysis

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 strategy and the macroeconomic situation into consideration. As a rule, Finanstilsynet divides its assessment of the institution's inherent risks into the following subcategories: credit risk, market risk, operational risk, liquidity risk and funding risk, risk of excessive leverage and ‘other risks’.

If weaknesses have been identified in the institution's management and control of the individual risk categories referred to in chapter 7, Finanstilsynet will take into consideration the risk this may entail for the institution. For small and less complex institutions, Finanstilsynet's assessment of risk related to the management and control of the individual risk categories is included in the assessment of the institution's internal governance, cf. chapter 6.

For a more detailed description of the assessment criteria that are emphasised in the assessment of the management and control of credit risk, market risk, liquidity and funding risk, as well as operational risk, see Finanstilsynet's guidelines (modules) published on Finanstilsynet's website (in Norwegian only) and EBA/GL/2022/03.[19]

This chapter specifies the assessment criteria that may be relevant in the assessment of the institution's risk exposure.

7.1 Credit risk

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 EBA/GL/2022/03.[20]

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 considered against the board's risk appetite, credit strategies and credit procedures. Finanstilsynet also assesses risk exposure in a forward-looking perspective in light of the institution's credit strategies, credit limits and the macroeconomic outlook.

In its assessment, Finanstilsynet attaches importance to:

- Non-performing exposures and how long they have been non-performing.[21]
- Forborne exposures.
- The institution's level of loan loss provisions, including provisions on the institution's performing high-risk portfolio and the level of provisioning on older non-performing

[19] Cf. EBA/GL/2022/03, sections 6.2.3 (credit risk), 6.3.3 (market risk), 6.4.4 (operational risk) and 6.5.3 (market risk)

[20] EBA/GL/2022/03 chapter 6.2

[21] A significant volume of exposures that have been non-performing for some time is considered to entail a higher risk for institutions with limited loan loss provisions.

loans. The assessments are made for both the overall portfolio and for relevant sub-portfolios. When assessing the volume of loan loss provisions, the level of existing collateral and their valuation are taken into account.

- Whether the institution's methodology for determining loan loss provisions is in accordance with the rules of IFRS 9.
- Whether the institution's granting and monitoring of loans is in line with the guidelines from the EBA.[22]
- Compliance with the Lending Regulations.[23]
- To what extent the institution’s pricing of loans covers the cost of capital/funding costs, and whether there is sufficient differentiation between loan products and between customer segments.
- The institution's exposures to property development projects.[24]
- Possible securitisation of portfolios and how this affects the risk to which the institution is exposed.
- Whether the institution has assessed ESG risks in its credit portfolio and in particular whether the institution has assessed the risk posed by climate change and the transition to a low-emission society.

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. It will also be considered whether special measures are required as part of the SREP (model risk). This also includes an assessment of whether the maturity parameter (M) reflects the actual risk.[25]

Finanstilsynet conducts regular stress tests of institutions' credit portfolios as part of its assessment of the prospective risk of losses in the institution’s loan portfolio(s). Estimates of loan losses based on such stress tests are also included in the risk analysis.

Credit-related concentration risk
When assessing the institution's credit-related concentration risk, Finanstilsynet considers whether the institution’s exposures are broadly diversified.[26] High concentration risk could make the institution particularly vulnerable to individual incidents. The analysis includes single-name concentrations, sectoral concentrations, geographical concentrations, product concentrations and collateral and guarantees concentrations. Finanstilsynet also assesses the volume of large exposures and their quality. See also the EBA's SREP guidelines.

7.2 Market risk

In its analysis of the institution's market risk exposure, Finanstilsynet assesses risk associated with items on and off the institution's balance sheet that may result in losses in the event of a change in market prices. The analyses of the individual types of market risk estimate potential losses, risk diversification and the liquidity of the positions in the event of sudden changes in material market risk factors. All material market risk is analysed. In addition to market risk

[22] EBA/GL/2020/06

[23] Regulations of 9 December 2020 no. 2648

[24] Cf. circular 2/2021

[25] Cf. EBA/GL/2022/03 sections 182 and 229

[26] Cf. EBA/GL/2022/03 sections 183-189

covered by the EBA's description of market risk, interest rate risk in the banking book (IRRBB)[27] and property risk are also included in the analysis of market risk. Finanstilsynet's module for assessing market risk provides further guidance on which elements Finanstilsynet attaches importance to. See also the EBA's SREP guidelines.[28]

Interest rate risk
Finanstilsynet analyses the institution’s market risk associated with positions in fixed-income securities, including derivatives with fixed-income instruments as underlying assets. The assessment also includes the institution’s investments in fixed-income funds, bond funds and money market funds. Interest rate risk associated with the banking book[29] (IRRBB) is assessed separately from interest rate risk in the trading book. IRRBB measurements are based on both the risk of changes in the economic value of equity (the EVE methodology) and the risk of changes in profits (NII methodology). In addition to effects on the interest margin, the risk analysis according to the NII methodology also includes changes in the value of securities, including any effects on the comprehensive income statement. Interest rate risk is assessed on the basis of the limits set by the institution's board of directors.

Equity risk
Finanstilsynet analyses the institution’s market risk associated with positions in equity instruments, including derivatives with equity instruments as underlying assets. The analysis comprises positions in both the trading book and the banking book. The trading book is assessed on the basis of the limits set by the institution's board of directors. No limits are normally set for the banking book. As a rule, the assessment is based on the institution’s reported positions.

Currency risk
Finanstilsynet analyses the institution's risk associated with exposures to various foreign currencies. The analysis comprises all financial instruments and other positions entailing currency risk. As a rule, the analysis is based on the limits set by the institution's board of directors for the banking book and the trading book.

Credit spread risk
Finanstilsynet analyses 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. As a rule, the analysis is based on the market value of the institution's actual positions in both the trading book and the banking book.

Property risk
Finanstilsynet analyses 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 analysis is based on the market value of the institution's actual holdings.

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[27] For the IRRBB, the risk of changes in profits is also assessed

[28] EBA/GL/2022/03 chapter 6.3.

[29] EBA/GL/2018/02 and the Basel Committee’s document: ‘Standards – Interest rate risk in the banking book, April 2016’

Other market risk
All other material market risk to which the institution is exposed is analysed, including, but not limited to, risks associated with international funding that is not otherwise covered in the analysis of market risk.

Finanstilsynet will also take the institution's own assessments of other types of market risk into account. 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 a suitable EGS strategy for market risk.

7.3 Operational risk

Finanstilsynet considers whether any extraordinary circumstances or significant changes may heighten the institution’s operational risk by affecting the management of the institution or the utilisation of the institution's resources, or heighten the risk of manual errors. The institution's use of subcontractors and partners, as well as management and control of outsourced activities, new and changed products, activities, processes and systems, are taken into consideration in the assessment of operational risk. In addition, Finanstilsynet reviews the institution’s contingency plans aimed at ensuring its ability to operate on an ongoing basis and limit losses in the event of severe business disruptions.

Finanstilsynet takes account of the institution’s own assessments of risk and capital needs related to operational risk, past losses (potential and actual losses), experience from on-site inspections, reporting of incidents and other external reporting, as well as other reporting from and contact with the institution. Finanstilsynet's module for assessing operational risk provides further guidance on relevant elements that may be included in the assessment. See also the EBA's SREP guidelines.[30]

Finanstilsynet considers whether operational events and actions that may undermine confidence, including lack of or weak consumer protection, are likely to result in higher losses and reduced profitability in the long term.

In the analysis, it is particularly relevant to emphasise:
- ICT risk, including the risk of cyber attacks (cyber risk)[31]
- Compliance risk
- Risk of fraud
- Legal risk
- Money laundering and terrorist financing risk
- Risk associated with the follow-up of outsourced services
- ESG risks, including physical and transition risks associated with climate change and the transition to a low-emission society
- Risk of internal and external reporting of inadequate quality
- Risk of inadequate contingency / business continuity plan
- Risk of errors in the development and use of internal governance models

[30] EBA/GL/2022/03 chapter 6.4.

[31] See EBA/GL/2022/03 section 305 h.

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

Behavioural risk
It could also be relevant to assess risk related to the institution's behaviour, including whether the bank's activities ensure an adequate level of consumer protection. Behavioural risk and inadequate, or weak, consumer protection entail increased operational risk in the form of loss of confidence and possible liability. Finanstilsynet considers the bank's behavioural risk, partly on the basis of the number of and changes in customer complaints. Finanstilsynet also assesses risk associated with other incidents or actions that could undermine confidence. An example could be lack of confidence as a result of non-compliance with ESG standards for the institution's products, or weak compliance with the AML legislation.

7.4 Liquidity and funding risk

In the analysis of the institution's liquidity and funding risk, it is relevant to consider whether the institution's liquidity and funding strategy, guidelines, limits, processes and models are proportionate to its size, activities and complexity. Finanstilsynet places emphasis on assessing how well prepared the institution can be considered to be in a liquidity crisis and/or funding crisis that affects the institution and/or the market in general. Furthermore, it is relevant to clarify whether the institution is exposed to the risk of money laundering and terrorist financing from a liquidity and/or funding perspective.

Liquidity risk
Finanstilsynet analyses the institution's development and the status of the liquidity coverage ratio, LCR, in total and per significant currency, at all levels of consolidation. Furthermore, the institution's other liquidity reserves, including spare covered bond capacity, are assessed. 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 for, developments in and status of stable, long-term and diversified funding by using the indicator for stable funding (NSFR), deposit-to-loan ratio, deposit composition, the share of market funding and the average remaining maturity of market funding, as well as concentrations in maturity structure and funding sources. The assessment of market funding includes an evaluation of possible requirements imposed on the institution with respect to subordinated debt (MREL).

For some institutions, it is also relevant to consider the significance of ESG risks for the institution’s current status and future liquidity and funding challenges.

7.5 Risk posed by 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 Tier 1 capital 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 (see also section 8.2).

Developments in the institution's leverage ratio in Finanstilsynet's stress tests will be given weight in the risk assessment.

7.6 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.

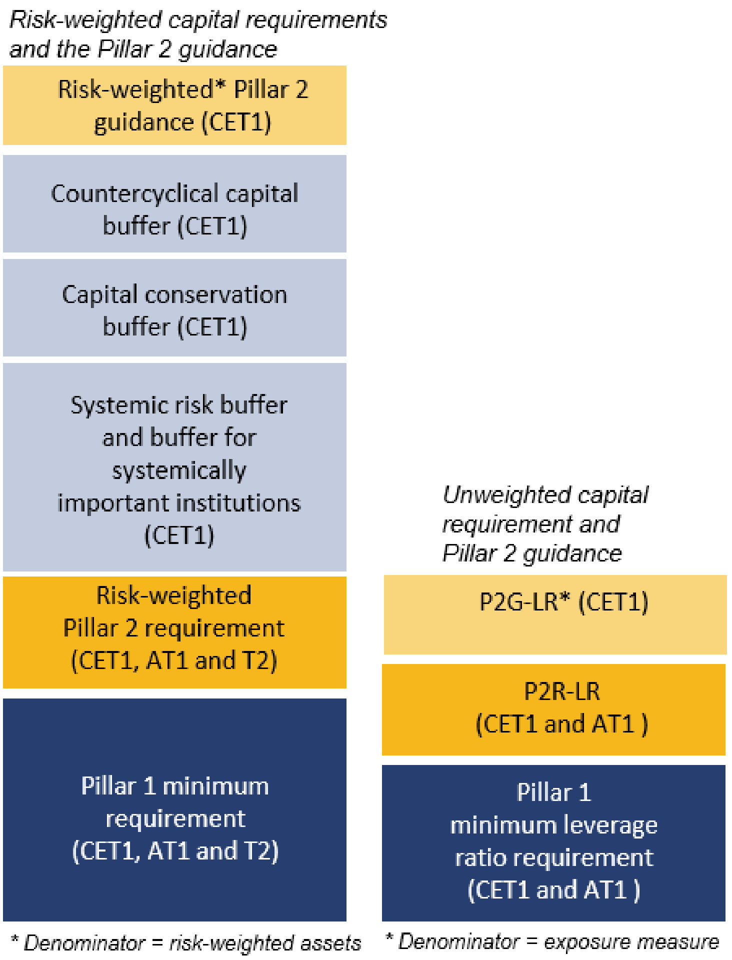
Overall risk assessment
In the risk assessments described in chapter 5 (business model), chapter 6 (internal governance) and chapter 7 (assessment of risk areas), Finanstilsynet ranks the institution's risk in one of four categories: ‘low risk’, ‘low to medium risk’, ‘medium to high risk’ or ‘high risk’. Liquidity and funding risk is ranked separately from the other risk areas. 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 assessment forms the basis for forming a view on the viability of the institution’s business model in the short and long term.

8 Assessment of overall capital needs

Finanstilsynet's assessment of the institution’s business model (chapter 5) and internal governance (chapter 6), together with the risk assessment of the institution's capital and liquidity situation (chapter 7) form the basis for assessing the institution's overall capital need, its capital need under Pillar 2 and its Pillar 2 guidance.

Figure 2 is an illustration of the institution’s total capital requirements and Pillar 2 guidance. The figure 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).

Figure 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

8.1 Assessment of capital needs under Pillar 2

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 Pillar 2 requirement and Finanstilsynet's procedure for determining the Pillar 2 requirement.

The Pillar 2 requirement applies at the highest level of consolidation unless otherwise specified in Finanstilsynet's decision. Capital used to meet the minimum requirement and the overall buffer requirement under Pillar 1 cannot be used to cover the need for capital under Pillar 2. Capital used to meet the risk-weighted Pillar 2 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.[32] 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.[33] For example, it may be appropriate to set

[32] Effective on 1 June 2022

[33] Cf. CRD Article 104a no.4

stricter requirements for the composition of capital to ensure compliance with the Pillar 2 requirement if the institution has a risk profile that may cause rapid and significant fluctuations in its CET1 capital ratio, or if the institution's ownership structure may have a strong impact on the institution's access to (common equity) Tier 1 capital. This may also be relevant for institution that for other reasons are assumed to have particular challenges raising new capital. 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 chapter 7, 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 circular. 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 7 and the criteria set out in Finanstilsynet's modules, this methodology forms 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[34], assessments of risk and overall capital needs[35], or the rules on large exposures[36], and other supervisory measures are not considered appropriate, Finanstilsynet will lay down a Pillar 2 requirement.[37] Requirements concerning institutions' ICAAP are discussed in further detail in appendix 1.

8.2 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.[38] Finanstilsynet shall set minimum leverage ratio requirements under Pillar 2. The Pillar 2 requirement for the risk

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

[35] Cf. the Financial Institutions Act, chapter 13-6, cf. CRD Article 75. See appendix 1

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

[37] Cf. CRD Article 104a no. 1 b

[38] Cf. CRR, section 8 of the preamble

of excessive leverage 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.[39] 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.[40] Finanstilsynet also assesses whether there are any signs of adjustments in exposures around the reporting dates that indicate that a Pillar 2 requirement should be set for the leverage ratio. 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.

8.3 More about the Pillar 2 guidance

Pillar 2 guidance
A financial institution shall in the overall capital assessment in the ICAAP specify its need for capital in the short and long term, and assess how this capital need can be met (Financial Institutions Act, section 13-6 subsection (3) and the Securities Trading Act, section 9-47 subsection (3)). Hence a capital plan must exist. Finanstilsynet's assumption and expectation is that the institution will set both its capital target and actual level of capital in such a way as to ensure an ample margin to the overall capital requirement consisting of the minimum requirement and buffer requirement under Pillar 1 and the Pillar 2 requirement for inherent risks. 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.

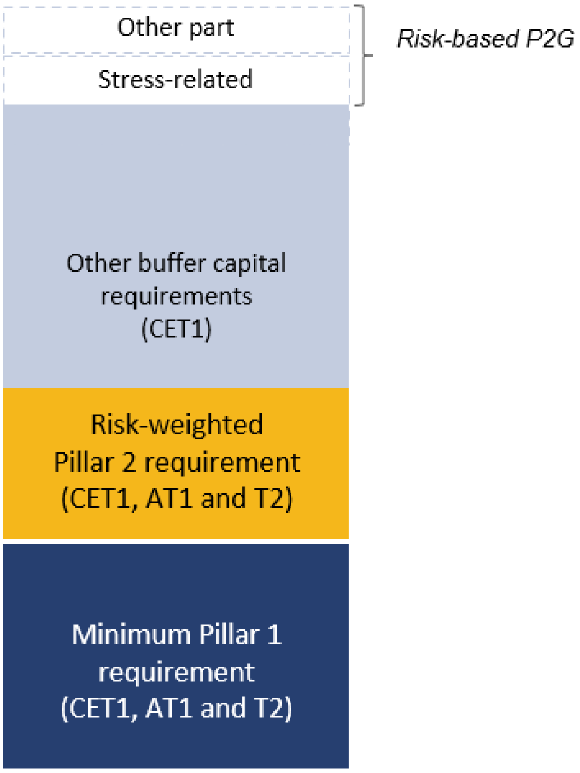
Finanstilsynet will, on the basis of the institution's assessment and its own assessments, communicate an expectation regarding the Pillar 2 guidance.[41] Finanstilsynet's expectation concerning the Pillar 2 guidance is based on an individual assessment of each institution and is communicated to the institution along with the decision on the institution's Pillar 2 requirement. The P2G shall consist of CET1 capital. Figure 3 illustrates capital requirements and the Pillar 2 guidance.

[39] Cf. CRD Article 104a no. 3

[40] EBA/GL/2022/03 section 7.3

[41] Cf. CRD Article 104b, cf. EBA/GL/2022/03 chapter 7.7.1 and annex 2

Chart 3: Illustration of capital requirements and the Pillar 2 guidance



Finanstilsynet uses stress tests to assess the level of own funds the institution is expected to hold in excess of its capital requirement. As a simplification, sensitivity analyses etc. can also be used.[42]

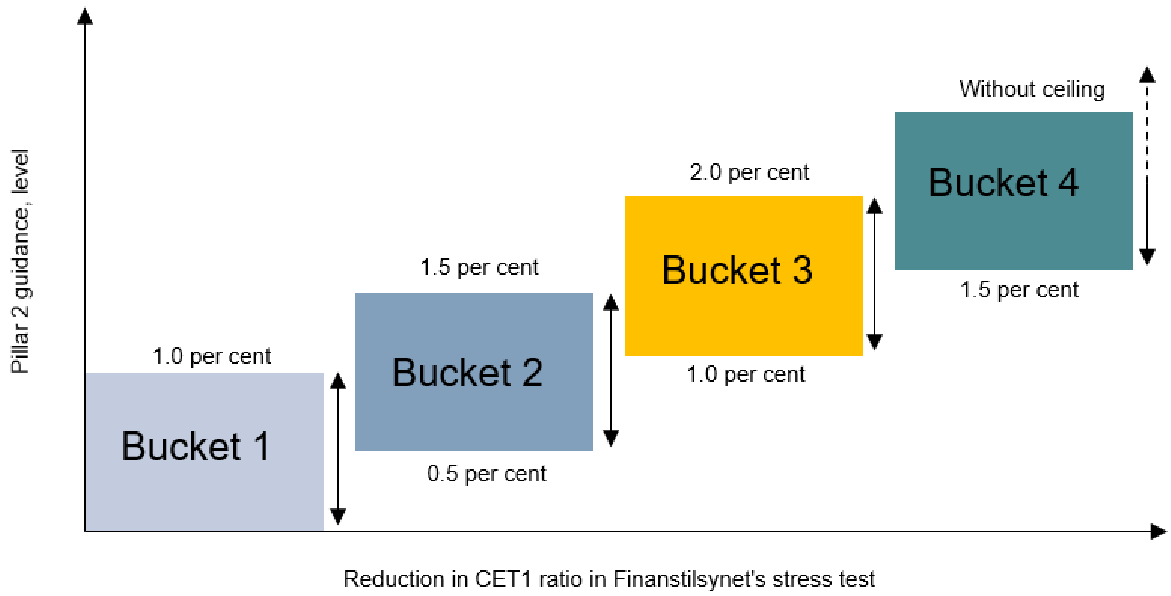
Based on the results of Finanstilsynet's stress test or sensitivity analyses (offsetting a decline in the CET1 capital ratio against the capital conservation buffer), each institution is placed in one of four buckets. Each bucket represents a lower and upper reference point that provides a basis for 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 take into account stress test results over time, as well as the institution's characteristics, risk profile, the institution's own stress test framework and other stress test results (see separate section on stress tests below).

The division of institutions into buckets in connection with Finanstilsynet's P2G expectations:

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.

[42] EBA/GL/2022/03 section 426.

Figure 4: 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 European Banking Authority (EBA) and the International Monetary Fund (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[43]. 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[44] 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 into account other factors that may cause variations in the bank's CET1 capital ratio.

9 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. Measures may also be necessary to correct significant weaknesses, errors or deficiencies that have been identified during on-site inspections and that have not been sufficiently remedied. Relevant measures may include the setting of Pillar 2 requirements. Other examples are closer dialogue with the institution, requirements for more frequent reporting, on-site inspections at the institution or other supervisory measures such as orders for corrective measures. In special cases, more invasive measures may also be relevant.

Finanstilsynet considers possible measures in light of the institution's size, complexity and business model. Finanstilsynet also assesses the severity of each case. Under normal circumstances, identified weaknesses, errors and deficiencies will require immediate action only in exceptional cases.

Ordinary supervisory measures, including orders for corrective measures
Finanstilsynet regularly applies relevant supervisory measures as part of its ordinary supervisory activity, including SREP and off-site and on-site inspections. The Financial Supervision Act, the Financial Institutions Act, sections 10-6, 13-6 and 14-6 provide the legal basis for Finanstilsynet's authority and use of policy measusres.[45] Finanstilsynet may communicate that the institution should improve its 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.

[43] Publication of Finanstilsynet's stress tests: https://www.finanstilsynet.no/en/publications/risk-outlook-reports/

[44] The largest banks reporting their securities exposure to Finanstilsynet in connection with the authority's overall risk assessment

[45] See details on extended authority in special situations below

Finanstilsynet may order the institution to rectify deficiencies, strengthen its capital adequacy (or not weaken it through dividends payments) or report more frequently.

The Financial Institutions Act, section 14-6 subsection (3) discusses supervisory measures when institutions fall short of requirements. If the institution's total CET1 ratio is below the sum of the minimum requirement, the Pillar 2 requirement and the overall buffer requirement, the institution shall immediately implement the necessary measures to rectify this. 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 does not have a sufficient P2G to meet Finanstilsynet's expectations, or if the level of capital has repeatedly been lower than the sum of the minimum requirement, buffer capital requirement and P2G, Finanstilsynet may, pursuant to the Financial Institutions Act, section 13-6 subsection (7) and the Financial Supervision Act, section 4 subsection (4), set a higher Pillar 2 requirement.[46]

The Financial Institutions Act, section 10-6 gives Finanstilsynet the authority, when necessitated by the institution's financial position, to order the institution to pay less dividend or not to pay dividend. Finanstilsynet may also order the institution to maintain higher own funds than the statutory minimum requirement, cf. the Financial Supervision Act, section 4 subsection 4. Automatic restrictions on overall disbursement of dividends and interest on Tier 2 capital and performance-based remuneration, see the CRR/CRD IV Regulations section 10, are triggered by failure to comply with the minimum requirement, the Pillar 2 requirement for inherent risk and the buffer requirement under Pillar 1.

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. According to the proposition, this may be relevant in situations where infringement of requirements for continued satisfactory operation other than capital requirements, is likely. In such cases, the conditions for intervention under the two provisions

[46] Cf. CRD Article 104a no.1e

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

If necessary, Finanstilsynet may, pursuant to the Financial Institutions Act, section 20-11, 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. 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 measures 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.

10 SREP assessment for institutions that are part of foreign groups for which supervisory colleges have been established

With regard to cross-border 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[47], including guidelines for the SREP. The SREP for cross-border groups is based on the same elements and assessments as those described in this circular. 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[48]). The preliminary analyses and assessments form the basis for the college's joint assessment. 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.

[47] Based on Articles 113 and 116 of EU Directive 2013/36/EU

[48] Cf. CRD Article 51

Appendices:

The appendices to the circular are published on Finanstilsynet's website in the same place as the circular.

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 3 capital needs for market risk
Appendix 3	Finanstilsynet's assessment of capital needs under Pillar 2 related to ownership in insurance undertakings

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