FINANSTILSYNET
THE FINANCIAL SUPERVISORY AUTHORITY OF NORWAY

Norges Bank
P.O. Box 1179 Sentrum
NO-0107 OSLO

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# Assessment of the level of the systemic risk buffer rate

## 1. Introduction

Finanstilsynet refers to the provision on the decision on the countercyclical capital buffer and advice on the systemic risk buffer established by royal decree on 3 September 2021 (in Norwegian only), according to which Norges Bank shall prepare a decision basis for the level of the systemic risk buffer rate. As part of this work, Norges Bank and Finanstilsynet shall exchange relevant information and assessments, cf. section 4.

This letter sets out Finanstilsynet's assessments of the design and level of the system risk buffer rate. The assessments are based on Finanstilsynet's assessments of the prospects for financial stability and the situation of banks as described in the Risk Outlook report, the report on financial institutions' performance for 2023 and solvency reports for financial institutions as at 31 December 2023, as well as the report on banks' losses and non-performing loans as at 31 December 2023 (the last three are available in Norwegian only).

Regulations concerning the systemic risk buffer are described in section 2. Risks in the financial system in Norway are described in section 3, while the solvency and capital adequacy of Norwegian banks are described in section 4. Section 5 discusses the possibility of a sectoral systemic risk buffer. Finanstilsynet's assessments are summarised in section 6.

## 2. Regulations concerning the systemic risk buffer

The systemic risk buffer requirement is intended to increase the resilience of the institutions to loan losses and other disruptions that may occur as a result of structural vulnerabilities in the economy and other persistent systemic risk, cf. section 26 of the CRR/CRD Regulations.

The systemic risk buffer shall help reduce banks' vulnerability to systemic risk not covered by other capital requirements, such as the countercyclical capital buffer and the buffer for systemically important institutions. Under the European capital adequacy framework, the systemic risk buffer requirement can also be designed to help reduce vulnerability related to exposures in individual sectors, cf. Article 133 of the CRD.

The systemic risk buffer requirement is 4.5 per cent and applies to exposures in Norway. The requirement came into effect on 1 January 2021 for banks using the advanced IRB approach and systemically important institutions. For banks using the standardised approach and institutions authorised to use the foundation IRB approach, a transitional measure was approved whereby the

FINANSTILSYNET
Revierstredet 3
P.O. Box 1187 Sentrum
NO-0107 Oslo

Phone no. +47 22 93 98 00

post@finanstilsynet.no
www.finanstilsynet.no

**Case officer**
Anneli Solberg
Dir. tel.no.
+ 47 22 93 96 14

requirement of a 3 per cent systemic risk buffer rate for the total risk-weighted exposure was valid until 31 December 2022. The transitional measure was extended, and on 1 January 2024, the 4.5 per cent requirement for domestic exposures for banks using the standardised approach and banks using the foundation IRB approach came into force.[1]

## 3. Risk in the Norwegian financial system

Financial shocks may have wide-ranging effects and be amplified in the financial system. Structural vulnerabilities in the financial system have an impact on how quickly and extensively shocks can spread. Norwegian banks are generally exposed to the same risk factors.

Households' high debt burden represents a significant structural vulnerability in the Norwegian financial system and has been on the increase for more than two decades. The debt burden is very high both in a historical perspective and compared to other countries, although it has decreased somewhat over the past two years. Almost all of the debt carries floating interest rates or has a short fixed-rate period. Many households have very high debt relative to income and the value of their property and are vulnerable to declining incomes, rising lending rates and falling house prices. If many households have to reduce their purchases of goods and services at the same time, it could have a negative impact on many companies' earnings and debt servicing capacity, which in turn could lead to an increase in losses on bank’s corporate lending.

The banks are heavily exposed to commercial real estate, and lending to this industry accounts for more than one-fourth of banks’ lending to non-financial corporations. For small and medium-sized banks, this proportion is around 40 per cent and has remained relatively stable in recent years. Experience from banking crises in Norway and other countries shows that sizeable losses may be incurred on lending to commercial real estate during crises.

The banks are reliant on funding in the money and securities markets. During periods of strong turmoil in these markets, it may be difficult for the banks to obtain market funding even when interest rates are at a level where liquidity and credit risk premiums are high. Covered bonds make up more than half of banks' market funding and also a large proportion of banks' liquidity reserves. The extensive cross-ownership increases the risk of financial problems at one bank spreading to other banks. The banks’ large holdings of covered bonds could create problems in a situation where many of them are in need of liquidity and wish to dispose of covered bonds.

Norway is a small, open economy. The Norwegian business sector is not very well diversified and could be hit hard by international turmoil and weak economic developments among key trading partners. The eight largest markets accounted for a total of 60 per cent of exports of goods from mainland Norway in 2023. On account of their international exposures, Norwegian banks could also be affected by international turmoil and weak economic developments, as experienced during the banking crisis in the early 1990s.

Global climate change and the transition to a low-emission economy also entail risks for Norwegian companies and Norwegian banks. Fossil energy is important for the Norwegian economy, and an abrupt transition to a low-emission economy could lead to significant transition costs. Analyses based on climate scenarios from the Network for Greening the Financial System (NGFS), among others, indicate that the banks may incur significant losses in some scenarios. The European

[1] For more on information on past developments / changes in the systemic risk buffer, see Finanstilsynet’s letter from November 2022 (in Norwegian only).

Commission has emphasised that the systemic risk buffer may capture physical climate risk and transition risk.

## 4. Norwegian banks' solvency and capital adequacy

Norwegian banks' average (weighted) common equity Tier 1 (CET1) capital ratio was 8.4 per cent at end-December 2023. At the same time, the CET1 capital requirement was 15.4 per cent (weighted average). The median margin to the CET1 capital requirement was 4.5 percentage points, which is 0.7 percentage points lower than at the same time a year earlier. The reduction must be seen in light of the increase in the systemic risk buffer requirement to 4.5 per cent as of 31 December 2023 for institutions using the standardised or the foundation IRB approach to calculate credit risk. In addition, the countercyclical capital buffer requirement increased by 0.5 percentage points, to 2.5 per cent, as of 31 March 2023.

New requirements concerning the composition of the Pillar 2 requirement entered into force for institutions with Pillar 2 decisions dated before 1 June 2022. The new requirements resulted in lower CET1 capital requirements for many banks.

Norwegian banks are highly profitable. The banks' return on equity was 14.0 per cent in 2023, which is close to 2 percentage points higher than in 2022. The main explanation for the rise in profits was significantly higher net interest income than in the preceding year.

Finanstilsynet has been commissioned by the Ministry of Finance (in Norwegian only) to assess how the amendments to the capital adequacy framework (CRR3/CRD6) can be implemented in Norwegian law.[2] The framework includes a new standardised approach for calculating capital requirements for credit risk and a new capital (requirements) floor for IRB banks. The consultation paper on CRR3 will be submitted to the Ministry by the end of May 2024, while the deadline for CRD6 will be set later.

## 5. About the sectoral systemic risk buffer

EU regulations allow sectoral systemic risk buffer requirements to be set in order to reduce banks' vulnerability to structural and cyclical systemic risks related to exposure to individual sectors. cf. Article 133 of the CRD. Several countries have introduced sectoral system risk buffers for residential or commercial mortgages.

Commercial real estate is a sector that could represent high risk in the face of a broad economic downturn.. However, considerable uncertainty attends risk assessments in individual industries. There is a high level of uncertainty in a number of industries. Commercial real estate is also a diverse industry, and experience shows significant contagion effects across industries. Thus, it is not obvious that a sectoral buffer for commercial real estate will give a more positive effect on vulnerability than a general systemic risk buffer.

Norway has introduced measures targeting the real estate sector in the form of a risk weight floor of 35 per cent for institutions using the IRB approach for exposures secured by commercial real estate.[3] Banks using the standardised approach are not permitted to include commercial real estate

[2] The '2021 banking package' entails changes in the Capital Requirements Regulation (CRR) and the Capital Requirements Directive (CRD IV). The changes are the final elements in the implementation of the Basel III recommendations in the EU.

[3] The risk weight floors apply until 31 December 2024 and are under review. Finanstilsynet's advice will be included in the upcoming CRR3 consultation document.

collateral when determining the risk weight. The introduction of a sectoral systemic risk buffer will further complicate the capital adequacy framework. It should be noted that no countries use both a sectoral and a general systemic risk buffer.

## 6. Summary

In Finanstilsynet's view, the structural vulnerabilities of the financial system have changed little since the level of the systemic risk buffer was set in December 2022. The debt burden remains high in both Norwegian households and non-financial corporations, and Norwegian banks' loan portfolios and funding structure show clear similarities.

History shows that underlying vulnerabilities can lead to crises in the financial system that can come suddenly, create significant market turmoil and spread rapidly between market participants, both nationally and internationally. The Norwegian economy and the Norwegian financial system are strongly exposed to setbacks in the international economy and turmoil in international financial markets. Geopolitical risk could remain high for a long time. Global climate change and the transition to a low-emission economy also entail risks for Norwegian companies and Norwegian banks.

In order to ensure financial stability and a resilient financial system, it is Finanstilsynet's view that the systemic risk buffer rate should be retained at the current level. Furthermore, Finanstilsynet finds that it will be preferable to have one general systemic risk buffer rate.

For Finanstilsynet

Per Mathis Kongsrud
Director General

Knut Haugan
Deputy Director General (acting), Risk Surveillance and Macroeconomic Supervision

*This document has been electronically approved and does not require handwritten signatures.*