FINANSTILSYNET
THE FINANCIAL SUPERVISORY AUTHORITY OF NORWAY

Macroprudential Surveillance: Policy Challenges for Central Banks and Supervisors

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Outline of presentation

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- Briefly on Finanstilsynet and the banking system in Norway
- Past episodes of financial instability in Norway
- Macroeconomic surveillance and supervision in Norway
- Macroprudential supervision and macroprudential tools

Financial stability – who does what?

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- Responsibility for safeguarding financial stability split between The Ministry of Finance, Norges Bank and Finanstilsynet
  - The Ministry of Finance has the overall responsibility for financial stability
  - Norges Bank and Finanstilsynet monitor institutions, markets and payment systems to identify threats to financial stability
  - Finanstilsynet responsible for supervision of institutions and market places
  - Norges Bank the lender of last resort
- The three authorities regularly publish assessments of financial stability
- Bilateral meetings to discuss stability issues. Tri-partite meetings to secure a common understanding, exchange information and coordinate measures
- No formal macroprudential committee established

Finanstilsynet – institutional setup

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- History of banking supervision starts in 1900
- Finanstilsynet the first integrated supervisor (banking, insurance, securities) in Europe, established in 1986, due to the emergence of financial groups and need for consolidated supervision (Denmark and Sweden followed in 1988 and 1991, resp.)
- An independent government agency reporting to the Ministry of Finance. Historically, supervision separated from the Central Bank
- FSAs mandate: To promote financial stability and well-functioning markets. FSAs strategy highlights i.a. risk based supervision and macroprudential supervision
- Norway not a member of EU. As an EEA (European Economic Area) member, Norway adopts EU directives and is an observer to the European Supervisory Authorities

The Norwegian banking sector

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- Financial groups/alliances of large importance

- Significant foreign penetration into the Norwegian banking market
  - Subsidiaries and branches (mostly Nordic) market shares of appr. 25 per cent

- Banking market less concentrated than other Nordic countries

- Banking sector assets 200 per cent of GDP

- Housing loans dominating banks' household exposures, close to 55 per cent of total exposures
  Commercial real estate and shipping most important corporate exposures

- Significant foreign funding of banks

Structure Nordic countries – some indicators

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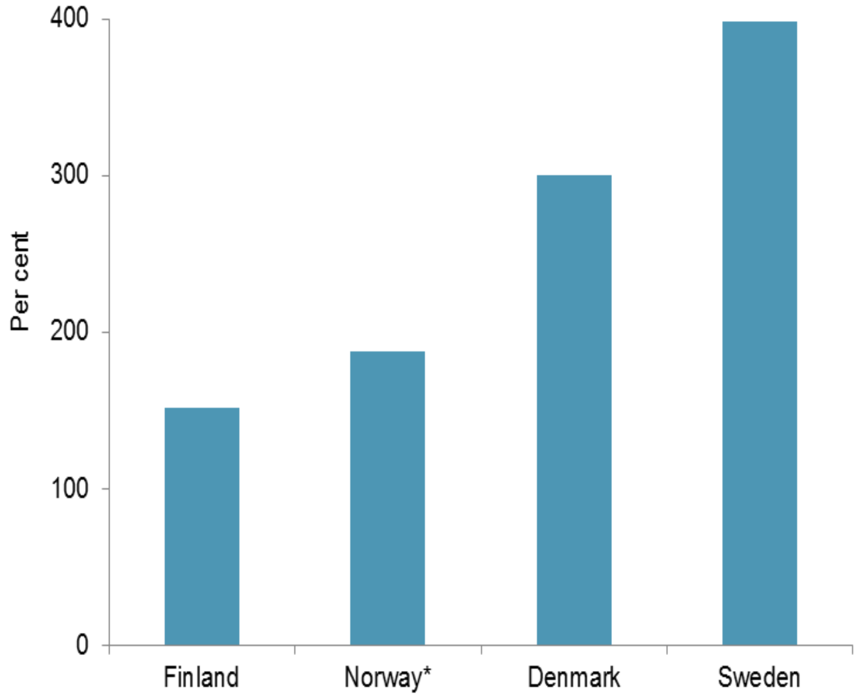
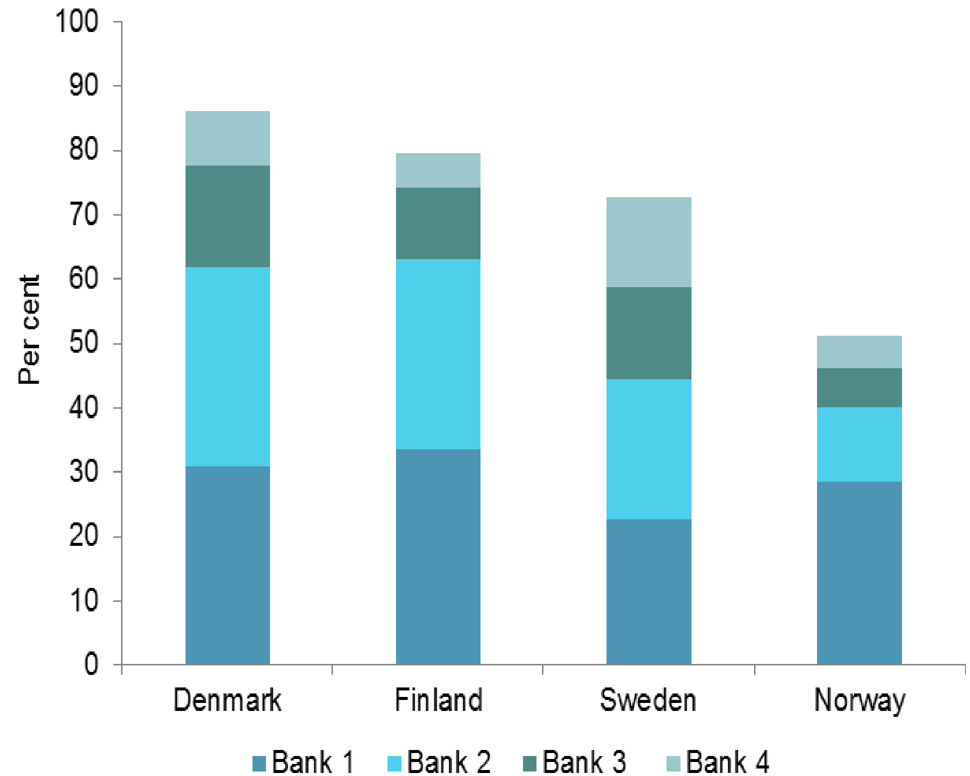
Consolidated banking assets relative to GDP (2012)



* Mainland Norway

- Sources: Nordic bank associations, supervisory authorities and central banks

Market shares domestic markets:
Four largest banks, per cent of loans



Sources: Nordic supervisory authorities and bank assocications

Past episodes of financial instability

Several financial crises in Norway; in the 1870s, in the 1890s, in the 1930s and in the 1990s

All of the crises had significant macroeconomic elements – preceded by economic booms, strong credit expansion, rising leverage and strong asset price inflation. The crises coincided with recessions

- 1870s: International downturn, affecting shipping
- 1899: Real estate and stock market crash, after a period of strong growth internationally and in Norway
- 1920s: Strong lending growth preceded the crisis. More than 130 banks failed
- 1990s: Nordic banking crises
  - Deregulation, exceptional lending growth, relaxation of regulation and supervision. A macro shock (oil prices) triggered a recession and large loan losses in banking.
  - The 3 largest banks nationalised, after writing down the value of equity to 0

The 1990-crisis is important for the establishment of macroeconomic surveillance in supervision

The international financial crisis

Main impacts on Norwegian banks: Liquidity and reduced economic activity

- No solvency issues, but a State Finance Fund established
- Low direct exposures to structured credit and exposed sovereign debt
- Banks' profitability remained good

The resilience of the Norwegian economy and financial sector due to i.a. the structure of the economy, large fiscal and current account surpluses, wide ranging policy actions (but no guarantees given), regulation and supervision

The strong growth in household debt and residential property prices continued after the crisis, posing challenges for authorities

Norway – Regulation and supervision

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- A consolidated approach to regulation and supervision covering the entire financial market
- Strict regulation of covered bond and a strong preference for high-quality capital
- A risk-based supervisory approach and strong emphasis on on-site inspections
- Regular dialogue and meeting with top management of the largest institutions
- Macroeconomic surveillance an integrated part of supervision

FSA and macroeconomic surveillance

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- Macroeconomic surveillance established in 1994, following the experiences from the 1990 banking crisis
- Integrated part of supervision, and a necessary supplement to supervision of single institutions, recognising that…

  …assessment of single institutions' profitability and financial strength have to be carried out with a view to the economic and financial cycles

- Staff with background in macroeconomics and finance was deemed necessary for an effective integration of micro- and macro supervision
- Financial stability reports since 1994 – to the FSA Board, discussed with the Ministry and Norges Bank
- Financial stability reports ("Risk Oulook") published yearly since 2003; biannually since 2010

FSA and macroeconomic surveillance

- Different triggers for systemic risk possible:
  - Macroeconomic shocks affecting several institutions/markets at the same time
  - Idiosyncratic shocks and contagion
  - Operational shocks in infrastructure
- Several sources of systemic risk:
  - Vulnerabilities in the non-financial sector (households and corporates)
  - Imbalances or "bubbles" in asset markets
  - Interconnectedness and/or common risk exposures in the financial system
  - "Structural" weaknesses – i.a. business models, risk controls, regulation, supervision
- Often mutually re-enforcing effects and non-linearities, aggravated by loss of confidence
- Systemic risk is emerging gradually, often as sectoral problems
- Information of emerging systemic risk must be identified not only from macro, but also from micro, in particular behavioural shifts due to changes in strategies, business models

Financial stability: Some current challenges – household debt and property prices

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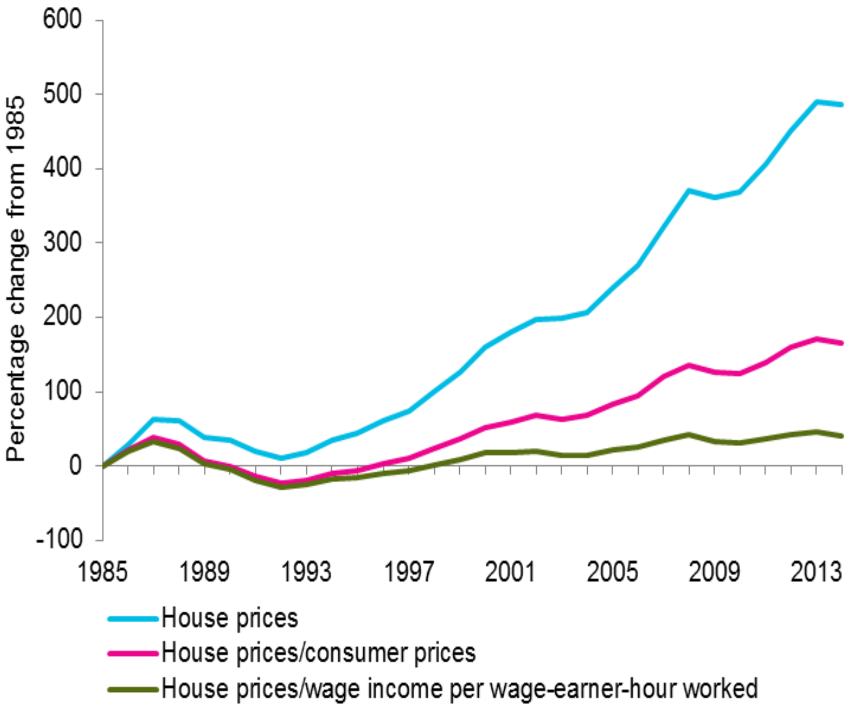
Residential property



Sources: EFF, Finn.no, Eiendomsverdi and Statistics Norway

Household debt

Sources: Statistics Norway and Norges Bank

Some current challenges – risk weights

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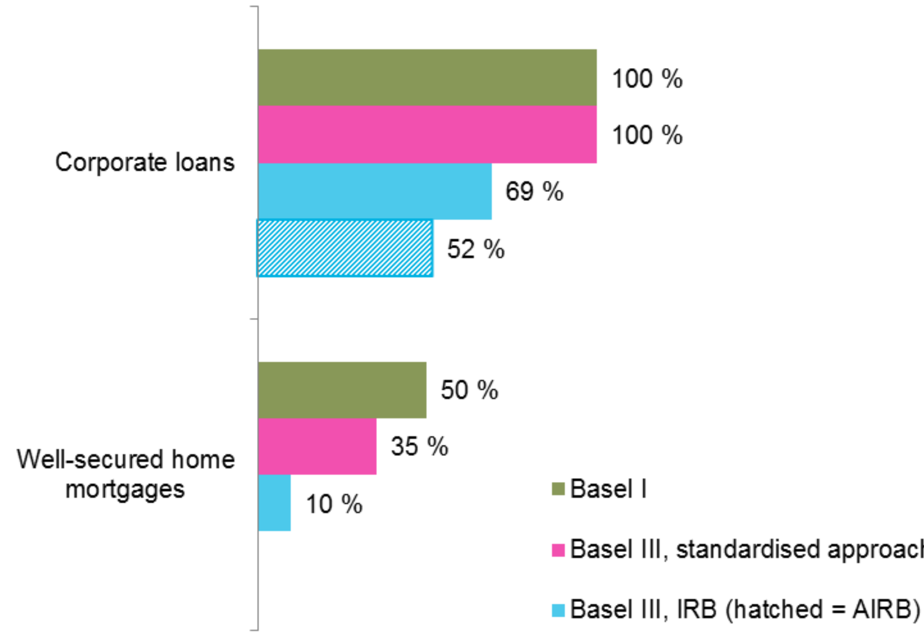
CET1 capital adequacy

Source: Finanstilsynet

Risk weights



Source: Finanstilsynet

Financial stability challenges – measures

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- Early implementation of CRD IV (Basel III) – as of 1 July 2013
  - Conservation and systemic risk buffer introduced, D-SIB buffer and countercyclical buffer in 2015
  - CET1-requirements increasing from 10 % in 2014 to 13 % in 2016 for D-SIBs and 11% for others

- Guidelines on mortgage financing introduced in 2010, tightened in 2011
  - Stresstests interest rates (5 percentage points), limits LTV (85 %), amortisation (LTV above 70 %)
  - Some flexibility allowed

- Increasing IRB risk weights on mortgages through floors on parameters in the models (LGDs, PDs)
  - Increasing risk weights from an average of 10 % to 20-25 %
  - Danish and Swedish FSAs has signalled voluntary reciprocity

- Continuation of Basel II-floor calculated on risk-weighted assets and emphasis on leverage ratios

- Active use of pillar II for idiosyncratic risk and systemic risk (not covered by buffers)

- Stress tests of households, corporates and banks (top-down/bottom-up) – in macroeconomic surveillance, on-site supervision and pillar II (ICAAP- SREP processes)

Policy challenges – some issues

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- Classification of micro and macroprudential tools unclear and overlapping, as is classification of bank-specific vs. system-wide and structural vs. countercyclical
- The institutional set-up of macroprudential tools should reflect synergies with microprudential supervision and monetary policy, and secure coordinated and effective use of tools
- National discretion within the (EU) single rulebook must be used to address national risk
- Effective use of macroprudential tools in markets with significant foreign branches requires reciprocity (mandatory and voluntary) and close cooperation between home and host authorities
- A more consistent approach to approvals and use of IRB-models must be reached
- Transparency of risk models and the use of backstops must be improved
- Financial stability analyses and macroprudential tools should include (groups of) small banks, insurance and other non-banks

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