

Advice on the countercyclical capital buffer 2017 Q1

Norges Bank's letter of 14 March 2017 to the Ministry of Finance

Norges Bank is responsible for preparing a decision basis and advising the Ministry of Finance on the level of the countercyclical capital buffer for banks four times a year. The buffer rate is set at 1.5 percent. In December 2016, the Ministry of Finance decided to increase the buffer rate to 2.0 percent effective from 31 December 2017, in line with Norges Bank's advice. The decision basis for Norges Bank's advice on the countercyclical capital buffer in 2017 Q1 is presented in the March 2017 Monetary Policy Report (1/17).

Banking regulation and macroprudential measures are the first line of defence against instability in the financial system. The premise for Norges Bank's assessment of the countercyclical capital buffer is that banks should build up and hold a buffer when financial imbalances are building up or have built up. The buffer rate will be assessed in the light of other requirements applying to banks. The buffer rate can be reduced in the event of an economic downturn and large bank losses with a view to mitigating the procyclical effects of tighter bank lending. The buffer rate should not be reduced automatically even if there are signs that financial imbalances are receding. Advice to reduce the rate will be based on factors such as information about market turbulence, significant credit supply tightening and prospects for substantial bank losses. The countercyclical capital buffer is not an instrument for fine-tuning the economy.

Norwegian banks have built equity capital in recent years in order to meet higher Common Equity Tier 1 (CET1) requirements, including the countercyclical capital buffer. Capital levels continued to rise in 2016 Q4. Banks' overall loan losses increased in 2016, particularly on oil-related exposures, but remained nonetheless at relatively low levels. With higher capital levels, banks will be more resilient to larger losses further ahead.

The European Systemic Risk Board (ESRB) recommends the calculation of technical reference rates for the countercyclical capital buffer (a buffer guide). The calculation is based on the credit-to-GDP ratio and its deviation from a long-term trend. The ESRB emphasises that there should not be a mechanical relationship between the reference rate and the level of the buffer, but that the buffer rate should be based on a broader decision basis. The reference rate for 2016 Q4 was 0.5 percent using Norges Bank's method of trend estimation and 0 percent using the Basel Committee method.

Norges Bank's assessment of financial imbalances is based on developments in credit and property prices and on banks' wholesale funding ratio.

Growth in household debt has been the main force behind the higher rate of growth in total credit relative to mainland GDP growth over time. Over the past half-year, household debt growth has accelerated and the debt-to-income ratio has continued to rise. Nevertheless, total debt has risen at about the same pace as GDP over the past year, reflecting lower growth in corporate debt, and in foreign debt in particular. Growth in bank lending to the corporate sector has fallen slightly, while growth in bond debt has picked up. Bond market risk premiums have edged down. Banks' wholesale funding ratio has been fairly stable for a longer period, and Norwegian banks have ample access to wholesale funding.

House prices have risen considerably more than household disposable income over the past year. House price inflation is high in many parts of the country, with house prices in Eastern Norway showing a particularly rapid rise. In oil-dependent regions, house price inflation is still weak. Estimated selling prices for office space in Oslo continued to rise in the second half of 2016, as a result of higher rents.

High house price inflation and a persistent rise in household debt ratios suggest that financial imbalances continue to build up, increasing the risk of an abrupt decline in demand and bank loan losses further ahead. Tighter requirements in the residential mortgage loan regulation, effective from January 2017, may have a dampening effect on household borrowing and reduce household vulnerabilities. The countercyclical capital buffer was increased in 2016 Q4, effective from the end of 2017. Banks are well-positioned to meet the capital requirements. There is no indication that creditworthy enterprises have any difficulty obtaining credit.

Norges Bank's Executive Board has decided to advise the Ministry of Finance to keep the buffer rate unchanged.

Norges Bank is responsible for advising the Ministry of Finance on countercyclical capital buffer rates for Norwegian banks' exposures in non-EU countries. For exposures in EU countries, the buffer rate in the relevant country must be recognised. In principle, countercyclical buffer rates in non-EU countries must also be recognised. For exposures in countries that have not set their own rate, the Norwegian buffer rate applies. The Ministry of Finance may set different rates for exposures in non-EU countries. For the time being, Norges Bank finds no basis for recommending different rates.

In preparing its advice on the countercyclical capital buffer, Norges Bank has exchanged information and assessments with Finanstilsynet (Financial Supervisory Authority of Norway).

Sincerely,

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