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S T A N D I N G   C O M M I T T E E
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RECOMMENDATION BY
THE STANDING COMMITTEE OF THE EFTA STATES

No. 1/2020/SC on the notification by Norway from 5 November 2020 of the use of a Systemic Risk Buffer according to Article 133 of Directive 2013/36/EU on access to the activity of credit institutions and prudential supervision of credit institutions and investment firms, as incorporated into the EEA Agreement by Decision of the EEA Joint Committee No 79/2019.

Whereas:

1. On 5 November 2020, the Norwegian Ministry of Finance ("Finansdepartmentet"), hereinafter "the Ministry", which is the national designated authority in charge of the application of a systemic risk buffer, hereinafter "SyRB", as referred to in Article 133 of Directive 2013/36/EU, which was incorporated into the EEA Agreement by Decision of the EEA Joint Committee No. 79/2019, notified the EFTA Standing Committee of its intention to raise the current SyRB on domestic exposures, hereinafter "the notification".

2. Currently, credit institutions in Norway are subject to a SyRB of 3% on all exposures, except for two systemically important institutions which are subject to a SyRB of 5% on all exposures. The notified measure is a SyRB of 4.5% and will apply to domestic exposures of all credit institutions authorised in Norway, including five subsidiaries of parents established in other Union's Member States. The buffer is intended to target systemic risks in Norway and promote domestic financial stability by safeguarding resilience in the financial system, along with ensuring continued adequate capital in banks in light of Norway's high-level of long-term systemic risk. Separately, the Ministry also notified its intention to set a buffer for two credit institutions categorised as Other Systemically Important Institutions (O-SIIs), pursuant to Article 131 of Directive 2013/36/EU. This will be set at a rate of 2% for one institution and 1% for the other.

3. The notified SyRB would apply from 31 December 2020 for all credit institutions, except credit institutions which do not use the "Advanced IRB Approach", as they would have a transitional period where the current buffer remains 3% on all exposures until 31 December 2022. The measure will be re-evaluated by the Ministry every second year.

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4. As the notified measure also concerns subsidiaries of parent undertakings established in other EEA States, the procedure described in subparagraph 3 of Article 133(14) of CRD IV, as adapted by Decision of the EEA Joint Committee No 79/2019, applies. The Ministry, as the designated authority in charge of the application of a SyRB, shall therefore notify its intention to the relevant authorities of the other EEA States along with the Standing Committee of the EFTA States and the European Systemic Risk Board (ESRB). The Standing Committee and the ESRB shall, within one month of the notification, issue a recommendation on the measures taken.

5. The SyRB is intended to mitigate long-term structural systemic risks in the Norwegian financial system. These risks stem mainly from propagation and amplification of shocks within the system itself, the Norwegian banking sector and the real economy.

6. In its reasoning for the notification, the Ministry points out that long-term structural systemic risks are comparatively high in Norway. Contributing to this high level of systemic risks, institutions in Norway have similar funding structures, rely significantly on wholesale funding (48% of their funding, including foreign wholesale funding), making them vulnerable to market turbulence. Additionally, they are interconnected, including through cross-holdings of covered bonds, and have similar and concentrated exposures towards real estate markets. For instance, about 60% of total lending of Norwegian credit institutions consists of lending for (residential and commercial) real estate. Under these circumstances, disruptions in the economy are amplified as they can severely affect multiple credit institutions both at the same time and in the same manner. This potential for amplification of risks is further substantiated by Norwegian banks' similarity in choice of business models, and interconnectivity through cross-holdings of covered bonds.

7. The Ministry has pointed out that the high real estate prices, both residential and commercial, along with high household debts in Norway are some of the key vulnerabilities in the Norwegian financial system that stem from the real economy. In that regard it should be noted that, in a historic context, household indebtedness in Norway, relative to disposable income, has been comparatively high which again results in systemic risk for the banking sector. The risk involved in Norwegian households using much of their income to service debt is further intensified by the fact that most Norwegian mortgages have floating interest rates, making even small disruptions capable of leading to severely impaired debt-servicing. Historically, exposures to commercial real estate (CRE) risks in previous crises have not only caused some of the Norwegian banking system's biggest losses but also contributed to solvency problems in the banking sector. The Standing Committee further notes that in June 2019, the ESRB issued a warning to Norwegian authorities where vulnerabilities in the Norwegian residential real estate (RRE) sector were identified as a source of systemic risk to financial stability and that those vulnerabilities needed to be addressed.[1]

8. The Ministry has pointed out that the credit institutions also operate in the Norwegian economy which is characterised by a relatively uniform corporate sector which is highly dependent on the petroleum sector. Since the petroleum sector constitutes 17% of GDP and 40% of total exports from Norway the possibility of lowered petroleum prices or

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[1] See https://www.esrb.europa.eu/pub/pdf/warnings/esrb.warning190923_no_warning~d3e4f2c135.en.pdf?4cf3e3031aa71bffaa0bd97a66b311ac

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reduced global demand are a significant risk to the economy as a whole. This risk has been mitigated to some extent in recent years by investing profits from the petroleum sector in securities in international financial markets. However, the COVID-19 pandemic and the ongoing transition to a greener economy may increase both short-term and long-term pressure on this systemically important sector. Such pressure could potentially cause a ripple effect to other sectors to which credit institutions are exposed. The Standing Committee notes in this respect that Norges Bank in its Financial Stability Report of 2020 states that ”[i]n the Norwegian oil sector, oil service companies in particular pose a risk to banks, and banks have incurred substantial losses on lending to this industry over the past five years”.[2]

9. According to the Ministry, the size, importance and concentration of the Norwegian banking sector amplify the systemic risks to the Norwegian economy. First, the banking sector's size compared to GDP is considerable, standing at approximately 225% of 2019's GDP. Second, the banking sector is highly important for the financing of the economy, as it serves more than 80% of gross domestic lending to the non-financial sector. Third, the banking sector is concentrated with the five largest banks accounting for 56% of total domestic lending.

10. In its assessment of the Ministry's reasoning, the Standing Committee has taken note of the International Monetary Fund's (IMF) Financial System Stability Assessment for Norway of 2020.[3] In line with the Ministry's assessment of the main issues pertaining to a high level of systemic risk, the IMF report recognizes that Norwegian banks' high exposures to domestic real estate, both residential and commercial, along with wholesale funding, are among the key underlying vulnerabilities. The IMF further notes that the banking sector's interconnectedness could result in significant shock amplification and that a deterioration in borrowers' debt servicing capacity could arise from a sharp slowdown in economic growth. As regards dependency on the petroleum market, the IMF notes that the impact of an abrupt transition to a low-carbon economy could be high given Norway's reliance on the production and export of oil.

11. In light of how the Norwegian banking sector is structured and the risks to which it is exposed, as described above, the Ministry considers it necessary that credit institutions overall are capable of absorbing losses that may occur as a result of severe shocks and disruptions in both the financial system and the real economy. It concludes that a SyRB of 4.5% for exposures in Norway is the most suitable measure to target substantial non-cyclical systemic risks present in Norway.

12. In assessing the Ministry's conclusion, the Standing Committee notes that stress tests conducted by the Norwegian authorities have shown that in situations that have low probability but are not unrealistic, many institutions would have a CET1 capital shortfall relative to overall capital and buffer requirements. The latest stress tests, performed by Norges Bank and Finanstilsynet (FSA) in November 2019 and June 2020 respectively, are based on a deep international recession with a strong increase in risk premia, causing serious consequences for the Norwegian economy. The FSA's stress test shows that in the course of the stress period the CET1 capital ratio of practically all of the 20 largest banking groups would fall below the overall CET1 requirement, including buffer

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[2] Norges Bank (2020), *Financial Stability Report*, p. 52.
[3] International Monetary Fund (2020), *Financial System Stability Assessment for Norway*, IMF Country Report no. 20/259, August.

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requirements and the Pillar 2 requirement. Additionally, 48 out of 84 of the other Norwegian credit institutions would not meet the overall capital requirements.

13. The Standing Committee further notes that the Ministry expects that, in the absence of the notified measure, future stress tests would reveal greater reductions in capital adequacy, forcing institutions to draw on a larger share of their combined buffer in order to maintain the lending activity. This would weaken the banking system's resilience towards the identified long-term systemic risks. If the SyRB requirement is set at 4.5% for domestic exposures, this would maintain adequate capitalisation based on the abovementioned risks, without leading to material increases in effective requirements for the larger institutions compared to the pre-2020 level. In this regard, the Ministry further notes that there are several aspects that are not captured by the stress test results, which may contribute to the credit institutions' potential losses being underestimated. For instance, it is assumed that credit institutions continue to have access to wholesale funding during periods of stress. Moreover, the Ministry notes that accumulated losses in the stress tests are lower than credit institutions' actual losses during the Norwegian banking crisis in 1988-1992. The Ministry also argues that the overall requirements implied by a systemic risk buffer of 4.5% for domestic exposures is also well within the range of estimates of socially optimal requirements.[4]

14. Having carefully considered the evidence provided by the Ministry, including the results of stress tests performed by the Norwegian authorities, as well as historical data on past severe crises in Norway, the Standing Committee is of the view that a SyRB level of 4.5% for domestic exposures can be considered appropriate for addressing the identified systemic risks threatening the stability of the Norwegian financial system. The Standing Committee further believes that under the current conditions a capital level that is achieved with a SyRB of 4.5% is necessary to maintain the banking systems' resilience towards the identified systemic risks. The Standing Committee notes in this respect that the Executive Board of the IMF concluded from its Financial System Stability Assessment of Norway in August 2020 that '[t]he authorities should guard against a weakening of capital requirements'.[5]

15. In assessing the effectiveness and proportionality of the measure, the Standing Committee notes the Ministry's view that a SyRB requirement of 4.5% for exposures in Norway will effectively contribute to maintain Norwegian institution's resilience and capacity to absorb losses at the level deemed necessary in light of the intensity of systemic risks. The CRR/CRD IV framework was recently incorporated into the EEA Agreement and in preparation for the Norwegian framework to align with the current framework, the Ministry has assessed the scope and calibration of the SyRB requirement, and concluded that the most effective way to mitigate the systemic risk will be to set the requirement at 4.5% for domestic exposures only. Beyond improving the consistency between the objective and design of the measure, this represents an alignment with the provisions of the CRR/CRD IV framework that facilitate reciprocation for domestic buffer rates.

[4] Basel Committee on Banking Supervision (2019), *The costs and benefits of bank capital – a review of the literature*, Working Paper 37, June.
[5] International Monetary Fund (2020), *Financial System Stability Assessment for Norway*, IMF Country Report no. 20/259, August, p. 2.

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16. The Ministry believes that for the larger Norwegian banks, constituting more than half the domestic banking system, a systemic risk buffer rate of 4.5% on domestic exposures is almost equivalent to the previous 3% buffer rate applicable to all exposures in terms of real capital requirements. They consider it proportional not only to the potential losses stemming from the structural risks in the Norwegian financial system, but also the intensity of those risks and the risk tolerance implied by their previous buffer decisions. It is furthermore worth noting that the current buffer rate of 3% on all exposures was calibrated when the Basel I floor applied and when there was no SME supporting factor. In the absence of the Basel I floor and with the SME supporting factor applying, the previous systemic risk buffer rate would, according to the Ministry, probably have been set at a higher rate in light of the level of systemic risk. As concluded by the Ministry, based on experience from previous crises and results from stress tests, the overall capital and buffer requirement has been proportional to the overall risks present in the financial system. Accordingly, the overall requirement should be maintained at approximately the pre-2020 level as the intensity of the systemic risks is similar to 2013, which would justify a SyRB rate set at 4.5%.

17. According to the Ministry, the COVID-19 pandemic has not led to any major changes in the structural features of the Norwegian financial system, and Norwegian credit institutions continued to satisfy capital and buffer requirements by an ample margin and were able to maintain lending to households and businesses during the COVID-19 pandemic. Meanwhile, in March 2020, the Ministry has lowered the countercyclical capital buffer from 2.5% to 1% as a short-term response to the potential impact from the COVID-19 pandemic.

18. In light of the above, the Standing Committee is of the view that the measure in question is both effective and proportionate as it contributes to mitigating the identified long-term structural risks in the Norwegian banking sector. The Standing Committee notes that the clearest evidence for this conclusion is found in the stress test results of the Norwegian authorities, which suggest that the measures will be effective for promoting financial stability in Norway by maintaining the capital level of Norwegian credit institutions at the necessary level for the conservation of their current loss-absorption capacity. In support of this conclusion about the proportionality of the measure, the Standing Committee notes that this implies that in actual terms there will be no significant increase of capital requirements for Norwegian credit institutions. For several of the subsidiaries of parent undertakings established in other EEA Member States the capital requirements will increase by close to 1.5 percentage point, but the Standing Committee notes that according to the Ministry these credit institutions have capital levels in excess of the requirements implied by a SyRB rate of 4.5% on Norwegian exposures. The Ministry acknowledges that some Norwegian credit institutions may need to increase their capital ratio somewhat to maintain a management buffer on top of the overall Pillar 1 and 2 requirements. Meanwhile, the transitional period until 31 December 2022 for banks not using the Advanced IRB approach, should ensure that the changes in the SyRB requirement do not result in undue increases in capital requirements for credit institutions that are not significantly impacted by the abolishment of the Basel I floor, and whose Pillar 2 requirements may have to be recalibrated once the higher SyRB applies to them after the transition period. This approach should mitigate distortions that the notified measure may cause and ensure that any adverse impacts on domestic banks and their lending capacity remain limited.

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19. The Standing Committee has also considered the Ministry's reasons for discarding other measures foreseen in Directive 2013/36/EU or in Regulation (EU) No 575/2013 (excluding Articles 458 and 459 of that Regulation), alone or in combination, as an appropriate way to address the identified macroprudential or systemic risk, taking into account the relative effectiveness of those measures.

20. Article 124 of Regulation (EU) No 575/2013 allows competent authorities to set higher values for risk weights of real estate exposures of credit institutions that use the standardised approach, based on financial stability considerations, the loss experience of exposures secured by immovable property, and forward-looking immovable property markets developments. The Ministry considers the risk weight of 35% for residential real estate exposures in Norway adequate for institutions using the Standardised Approach. For commercial real estate exposures, higher risk-weights have already been set, based on paragraph 2 of this Article, varying between 100% and 150%, depending on the counterparty's rating.

21. Under Article 164 of Regulation (EU) No 575/2013, competent authorities may, where appropriate on the basis of financial stability considerations and forward-looking immovable property markets developments, set higher minimum values of exposure-weighted average Loss Given Default for exposures secured by immovable property in their territory. For retail exposures secured by residential property in Norway, a higher Loss Given Default floor of 20% has been applied since 2014 to address uncertainty associated with internal credit risk models.

22. The Standing Committee notes that Articles 124 and 164 of Regulation (EU) No 575/2013 have already been used to some extent to address certain risks. It also notes that the notified measure intends to address broader long-term systemic risks than the specific property market developments that can be targeted under Articles 124 and 164 of Regulation (EU) No 575/2013. These systemic risks are the similar funding structures of credit institutions, their interconnectedness and their similar and concentrated exposures towards real estate markets and the Norwegian economy with a not very diversified corporate sector, while household debt levels are high.

23. Where a competent authority determines that credit institutions with similar risk profiles are or might be exposed to similar risks or pose similar risks to the financial system, it currently may, under Article 103 of Directive 2013/36/EU, apply the Supervisory Review and Evaluation Process (SREP) to those institutions in a similar or identical manner. Article 104 of Directive 2013/36/EU provides a set of supervisory powers to the competent authority in the application of Article 103 of that Directive, including additional own fund requirements. The Ministry argues that institution-specific pillar 2 requirements pursuant to Article 104 of Directive 2013/36/EU should be tailored to each institution's specific situation, and that such requirements may target certain elements of structural systemic risks, but only to an extent where the risks are not general features of the banking system. In support of this view, it considers that Directive 2019/878 clarifies that the institution-specific nature of Pillar 2 requirements should prevent their use as a tool to address systemic risks. The Standing Committee notes that Pillar 2 measures are indeed primarily meant to address institution-specific risks and are also less transparent than a systemic risk buffer.

24. Article 131 of Directive 2013/36/EU mandates designated authorities to identify other systemically important institutions (O-SIIs) and set or reset an O-SII buffer for those

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institutions. The Ministry has separately notified the intention to set O-SII buffers for two systemically important institutions. It considers these buffers complementary, as the O-SII buffers address part of the risk of a concentration of systemically important institutions, while the systemic risk buffer addresses other long-term non-cyclical systemic risks. According to the Minstry, a number of other credit institutions are big enough to potentially amplify systemic risks in the Norwegian banking sector, while remaining too small to be identified, by the Ministry, as domestic systemically important on an individual basis. The Standing Committee considers that Article 131 of Directive 2013/36/EU is not meant to address all types of long term non-cyclical systemic or macroprudential risks. The O-SII buffer would not be the appropriate tool to address long term non-cyclical systemic or macroprudential risks affecting the banking sector as a whole.

25. The countercyclical buffer referred to in Article 136 of Directive 2013/36/EU applies to all non-financial private sector exposures located in a jurisdiction. The Ministry argues that the countercyclical buffer is designed to address a different form of systemic risk, stemming from cyclicality in the financial system. The Standing Committee concurs with this assessment.

26. After examining the arguments put forward by the Ministry, the Standing Committee agrees with the Ministry that existing measures in Directive 2013/36/EU or in Regulation (EU) No 575/2013 (excluding Articles 458 and 459 of that Regulation), alone or in combination, would be relatively less effective in sufficiently and adequately addressing the identified risk.

27. As regards the potential impact on the internal market, the Standing Committee notes that there is no indication that the notified measure has a disproportionate effect on the five subsidiaries of credit institutions established in other EEA States. Additionally, in order to reduce the potential for leakages to foreign institutions that are active in Norway through branches, the Ministry plans to request reciprocation of the SyRB for all EEA institutions with exposures to Norway. The Standing Committee considers that this is important in view of the comparatively strong presence on the Norwegian lending market of banks from other Nordic countries, with a view to preventing regulatory arbitrage and avoiding leakages through branches. There are specific Memoranda of Understanding in place to promote cross-border financial stability and ensure adequate prudential supervision of significant branches of financial institutions operating in the Nordic-Baltic region.[6] The Standing Committee notes that the reciprocation request and the higher capital requirements this would imply for foreign credit institutions will be assessed by the ESRB when the Ministry will request the ESRB to recommend to its members to reciprocate the measure.

28. Given the high degree of interconnectedness with the financial systems of other Nordic countries, the Standing Committee expects the notified measure to be conducive to financial stability to the extent that regulatory arbitrage and leakages can be avoided by reciprocation of the notified measure for material exposures of foreign credit institutions to the Norwegian market, including the operations of any significant foreign bank branches.

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[6] See https://www.regjeringen.no/contentassets/ff0c28c162ca43f39b585d7c9f94dab5/nbsg-mou_2018.pdf

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29. Considering all the factors above, as required by Art. 133 of CRD IV, having reviewed the notification with Norway and consulted with relevant parties to this process, the EFTA Standing Committee concludes that the systemic risk buffer of 4.5% on domestic exposures does not entail disproportionate adverse effects on the whole or parts of the financial system of Norway or of the EEA as a whole. Neither does it form or create an obstacle to the proper functioning of the internal market.

HAS ADOPTED THIS RECOMMENDATION:

1) The systemic risk buffer notified on 5 November by the Norwegian Ministry of Finance ("Finansdepartmentet") according to Article 133(11) of Directive 2013/36/EU as adapted by Joint Committee Decision No. 79/2019, is justified, suitable, proportionate and effective to address the systemic risks for which it is intended. The Standing Committee of the EFTA States further notes that:

   a. the dimension of the identified systemic or macroprudential risks constitutes a threat to the stability of the Norwegian financial system of such nature that the introduction of a systemic risk buffer rate of 4.5% for domestic exposures is justified;

   b. the notified measure is likely to be effective and suitable to mitigate the risk in a proportionate manner;

   c. other macroprudential measures in Directive 2013/36/EU or in Regulation (EU) No 575/2013, alone or in combination, would be relatively less effective in sufficiently and adequately addressing the identified risk;

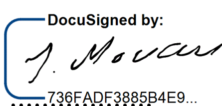
   d. the notified measure, including its application to subsidiaries whose parents are established in other EEA States, does not entail disproportionate adverse effects on the financial system of Norway or of the EEA as a whole and does not constitute an obstacle to the proper functioning of the internal market.

2) The Standing Committee of the EFTA States does not recommend any changes to the notified measure in view of its effects on subsidiaries of credit institutions established in other EEA States.

Done at Brussels, 4 December 2020

For the Standing Committee

The Chair



The Secretary-General