DET SYSTEMISKE RISIKORÅD

# Activation of the countercyclical capital buffer on the Faroe Islands

14 December 2021

The Systemic Risk Council *recommends* that the Minister for Industry, Business and Financial Affairs activates a countercyclical capital buffer at a rate of 1 per cent for Faroese exposures from 31 March 2023.

The countercyclical capital buffer requirement will take effect 12 months after the Minister has announced an increase. The institutions thus have time to adjust. The Government is required, within a period of three months, either to comply with the recommendation or to present a statement explaining why the recommendation will not be complied with.

Føroya Váðaráð, the Faroese Systemic Risk Council, supports this decision. [1]

The Systemic Risk Council is responsible for identifying and monitoring systemic financial risks on the Faroe Islands and can recommend macroprudential measures relating to the banks on the Faroe Islands. The purpose of introducing a countercyclical capital buffer is to reduce the real economic downturn that would otherwise follow in the event of an inexpedient hard tightening of households' and companies' access to credit during periods of stress in the financial system. The Minister for Industry, Business and Financial Affairs is responsible for laying down capital buffer requirements on the Faroe Islands, including the countercyclical capital buffer rate.

The Council sets the countercyclical capital buffer rate based on an overall assessment of the development in the financial system.[2] In addition to a number of indicators of financial system development, the Council also includes other relevant information, such as other policy measures, as well as current and future requirements to be met by the institutions.

The Council is ready to recommend a reduction of the buffer rate with immediate effect if stress occurs in the financial system and there is a risk of severe tightening of lending to households and companies.

To ensure a level playing field for Faroese and foreign banks with exposures on the Faroe Islands, it is mandatory by law for EU countries[3] that institutions in other countries recognise the countercyclical capital buffer rate of 1 per cent. for Faroese exposures.[4]

The Council will continuously assess the level of the countercyclical capital buffer rate on the Faroe Islands. The Council has currently no intention to further increase the

[1] In 2016, the Faroe Islands decided to set up a Faroese Systemic Risk Council. As regards the areas of responsibility controlled by Denmark in the financial area, the Faroese Systemic Risk Council may submit opinions to the Systemic Risk Council in Denmark.

[2] See the Council's method paper on setting the buffer rate (link).

[3] The same applies to countries with which the EU has entered into agreements in the financial area, including the Faroe Islands and Norway.

[4] Read more about recognition of other countries' measures on the Council's website.

countercyclical capital buffer rate. If there are signs of increased risk build-up, the Council will recommend a further increase of the buffer rate.

## Grounds

Following a recommendation from the Council, the increase in the general systemic risk buffer rate from 2.0 to 3.0 per cent on the Faroe Islands was temporarily suspended in March 2020 in response to the uncertainty and challenges connected with the spread of covid-19. The systemic risk buffer was introduced to cover structural risks in the Faroese economy. The Faroese economy is small and open with a concentrated corporate structure that largely depends on fisheries and fish farming. This makes the economy vulnerable to negative economic shocks which, with direct and indirect effects, may lead to losses in the financial sector and amplify fluctuations in the real economy. Historically, the Faroese economy has seen large fluctuations and with great variation in the banks' impairment charges. The Council finds that the Faroese financial sector is vulnerable to the structural factors characterising the Faroese economy.[5]

In addition to the structural risks, there are signs of a build-up of cyclical risks on the Faroe Islands. The economy is booming with high house price growth and credit growth. [6] In the event of sudden economic reversals, the Faroese banks risk incurring increased losses. The Council finds that a countercyclical capital buffer can address these vulnerabilities.

In light of this development, the Systemic Risk Council finds that the temporary reduction of the capital requirement on the Faroe Islands is to be discontinued. Covid-19 showed that it is an advantage to have a capital buffer that can be released if stress arises in the financial system. The Council therefore recommends maintaining a general systemic risk buffer rate of 2 per cent and instead setting a countercyclical capital buffer rate of 1 per cent of Faroese exposures. This will bring the level of the institutions' total capital adequacy requirements back to the situation before covid-19. The Council assessed the level of the institutions' total capital adequacy requirements in its analysis of 4 March 2020.

## The purpose of the buffer is to increase the institutions' resilience and ensure credit granting during periods of financial stress

The countercyclical capital buffer is an instrument used to make the institutions more resilient by increasing the requirement for their capitalisation during periods in which risks build up in the financial system. If financial stress occurs with a risk of a severe tightening of credit granting, the buffer can be reduced with immediate effect, thus releasing capital to the institutions.

To the extent that the institutions do not use the released capital to absorb losses, they may use it for new lending or to secure their excess capital adequacy. This improves the possibility for credit institutions to maintain an adequate level of credit granting during periods of stress in the financial system. The buffer thus contributes to limiting negative effects on the real economy in the event of financial stress.

The Faroese banks can already comply with a countercyclical capital buffer requirement of 1 per cent based on their current capitalisation levels.

The requirement that the banks must maintain a countercyclical capital buffer is not a hard requirement. Banks that do not comply with the requirement will therefore not lose their banking licence. Instead, the banks will be required to submit a capital conservation plan to

[5] See indicators in the Council's recommendation for an increase of the systemic risk buffer rate on the Faroe Islands from April 2018 (link).

[6] The boom has regained momentum, Analysis of the Faroese economy, Danmarks Nationalbank, 18 November 2021.

the Danish Financial Supervisory Authority, and bonus and dividend payments etc. may also be restricted if they fail to meet the combined capital buffer requirement.[7]

## Other capital adequacy requirements

The Council also takes other policy measures into account in its reflections on the countercyclical capital buffer rate. Other current requirements as well as the phasing-in of future requirements for the institutions are also taken into consideration.

### MREL requirement

The MREL requirement is a minimum requirement for the institutions' eligible liabilities (MREL). The MREL requirement is set by the Danish Financial Supervisory Authority and will be phased in gradually for the Faroese institutions towards July 2025. The MREL requirement concerns eligible liabilities that can absorb losses and recapitalise an institution in connection with resolution. The MREL requirement differs significantly from the countercyclical capital buffer. The purpose of the MREL requirement is to ensure that the institutions can be restructured or wound up without the use of government funds, and without such resolution having any substantial negative impact on financial stability. This purpose differs from the purpose of the countercyclical capital buffer, which is to make it possible for credit institutions to maintain an adequate level of credit granting during periods of stress in the financial system. The MREL requirement can be met with several types of capital and debt instruments, whereas capital buffer requirements can only be met with Common Equity Tier 1 capital.

With their current capital level, the institutions can meet a countercyclical capital buffer of 1.0 per cent on top of their current MREL and buffer requirements. The MREL requirement will increase in the coming years, as it will be phased in towards July 2025. It is assessed that the institutions have sufficient time to retain earnings and issue MREL debt to meet the fully phased-in MREL requirement.

The Council's recommendation is in compliance with current legislation.

*Lars Rohde, Chairman of the Systemic Risk Council*

[7] In addition to the countercyclical capital buffer, the combined capital buffer requirement comprises the general systemic risk buffer, the capital conservation buffer and a SIFI buffer for systemically important banks, the so-called SIFIs, see 'Executive order on Calculation of the Combined Capital Buffer Requirement etc.' (*Bekendtgørelse om opgørelse af det kombinerede kapitalbufferkrav mv.*) issued by the Danish Financial Supervisory Authority on 16 December 2014 and the related memo 'Provisions on a capital conservation plan and calculation of the maximum distributable amount' (*Bestemmelser om kapitalbevaringsplan og opgørelse af det maksimale udlodningsbeløb*) on the Danish Financial Supervisory Authority's website.

## Statements from the representatives of the ministries on the Council

"Legislation regarding the Systemic Risk Council stipulates that recommendations addressed to the government must include a statement from the representatives of the ministries on the Council. Neither the representatives of the ministries nor the Danish Financial Supervisory Authority have the right to vote on recommendations addressed to the government.

The government will await the decision of the Faroese government with a view to assessing whether the proper conditions exist for complying with the recommendation. Against that background, the government will decide on the recommendation from the Systemic Risk Council within a period of three months."

# Appendix A – Indicators

The Council includes a number of selected key indicators in its assessment of the buffer rate to capture the build-up of systemic risk at various stages in the financial development. Supplementary indicators and other relevant information are also taken into account in the assessment to provide a more detailed picture than that shown by the key indicators.

The early stage of an economic upswing is often characterised by increasing risk appetite among investors. This is reflected in higher asset prices, including prices of residential and commercial properties, and eased credit standards for households and companies. At a later stage in the financial development, households and companies may increase their debt in the expectation that property prices will continue to rise. This means that some indicators, such as property prices, signal the build-up of systemic risk ahead of other indicators, for example lending to households and companies.

## Property market and credit development[8]

There are signs of risk build-up in the housing market, where a high activity level and large price increases have occurred since 2013 and especially in 2020. The overall credit growth for Faroese households is increasing, but remains moderate. Homeowners on the Faroe Islands predominantly have variable-rate loans and are therefore particularly exposed to interest rate increases.

There is high credit growth for the corporate sector on the Faroe Islands, where the overall measure covers high credit growth for several industries. This includes industries that, by their nature, are more vulnerable to structural and external shocks, including fisheries and fish farming, but also more cyclically sensitive industries, such as trade, transport etc., as well as building and construction. With double-digit growth rates for several industries, risks are built up, as loans raised in periods of economic expansion may prove uncertain and result in losses if the cyclical economic trends reverse.

## Model-based indicators

Estimates of the financial cycle show that the financial development is either on an upward trajectory or at a high level, see chart a8. The estimates should be interpreted with caution as they do not provide an accurate picture of the current financial cycle. For example, the end of the data period is associated with some uncertainty, the so-called end-point problems. However, the method applied reduces this uncertainty.[9] An analysis of the financial cycle in Denmark performed by Danmarks Nationalbank shows that the financial cycle is driven primarily by fluctuations in house prices and lending and that house prices tend to move ahead of lending.[10]

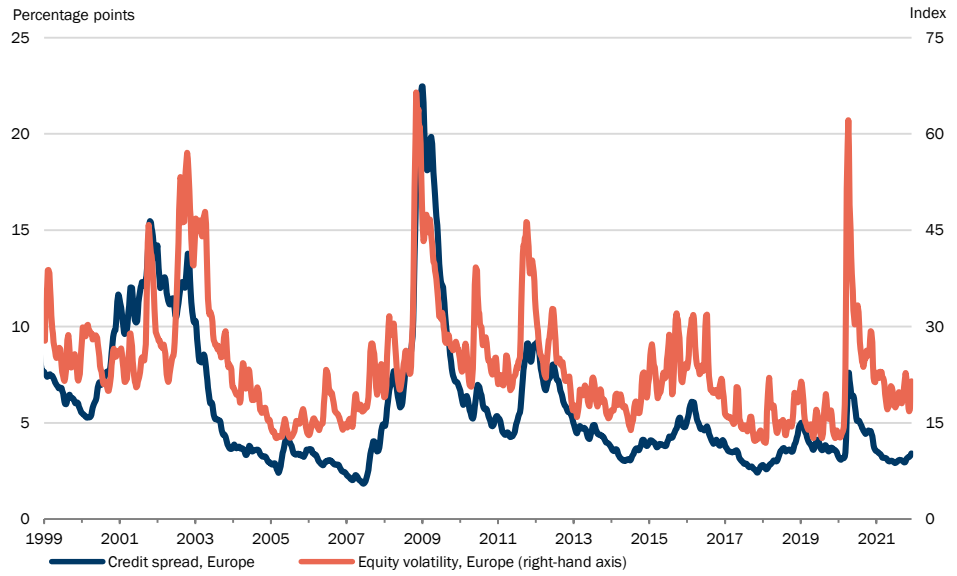
[8] The above credit development covers lending from both Faroese and Danish institutions.

[9] See the addendum on page 54 in Grinderslev et al., Financial Cycles: What are they and what do they look like in Denmark?, *Danmarks Nationalbank Working Paper*, No. 115, June 2017.

[10] See Oliver Juhler Grinderslev, Paul Lassenius Kramp, Anders Kronborg and Jesper Pedersen, Financial Cycles: What are they and what do they look like in Denmark?, *Danmarks Nationalbank Working Paper*, No. 115, June 2017.

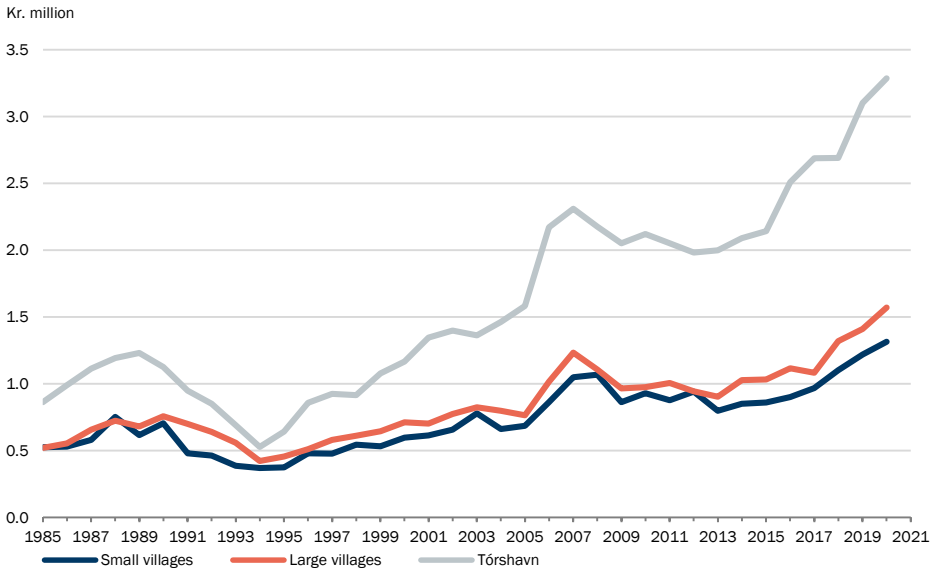
# Chart pack: Indicators

**Credit spread and equity volatility** Chart A1



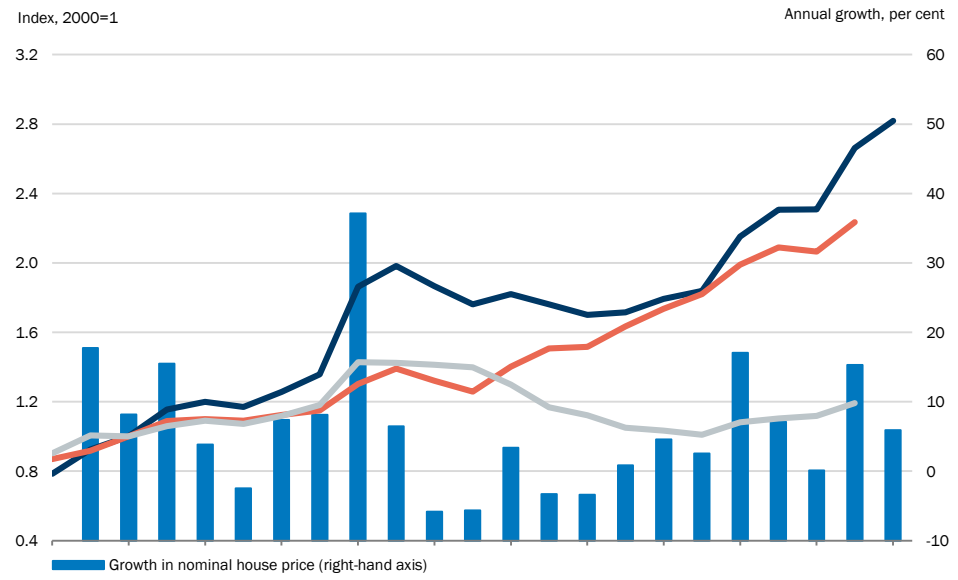

Note: The credit spread is the yield spread on high-yield corporate bonds in euro relative to government bonds. Equity volatility is measured by the implied volatility of options in the Stoxx Europe 600 stock index, VSTOXX (European VIX).
Source: Thomson Reuters and Bloomberg.

**Average traded prices for houses** Chart A2




Note: Current prices.
Source: Hagstova Føroya.

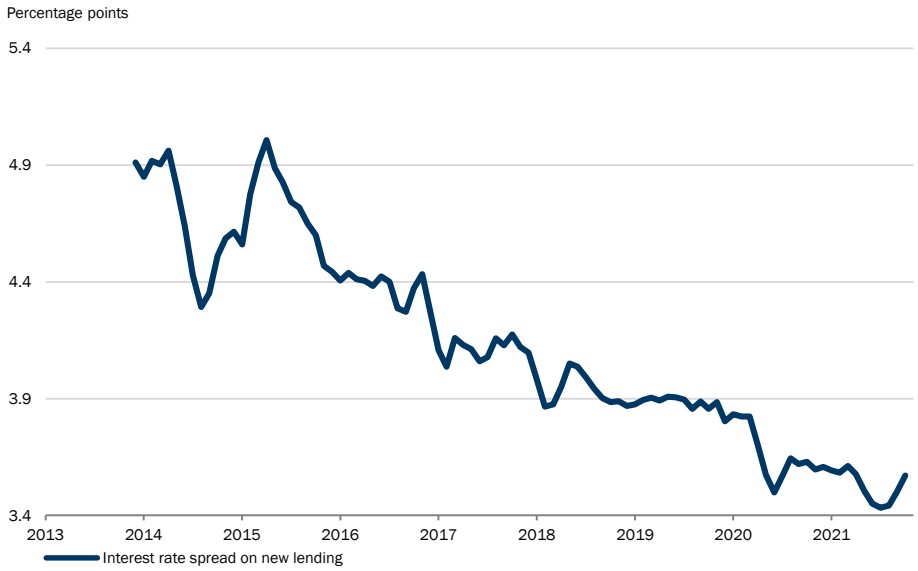
**House price-to-income** Chart A3




Note: Income is measured as the gross national disposable income and house prices are calculated as the average annual house price in Tórshavn. The gross nominal disposable income in 2016 and 2017 is an estimate from Hagstova Føroya (13 June 2018).

Source: Hagstova Føroya.

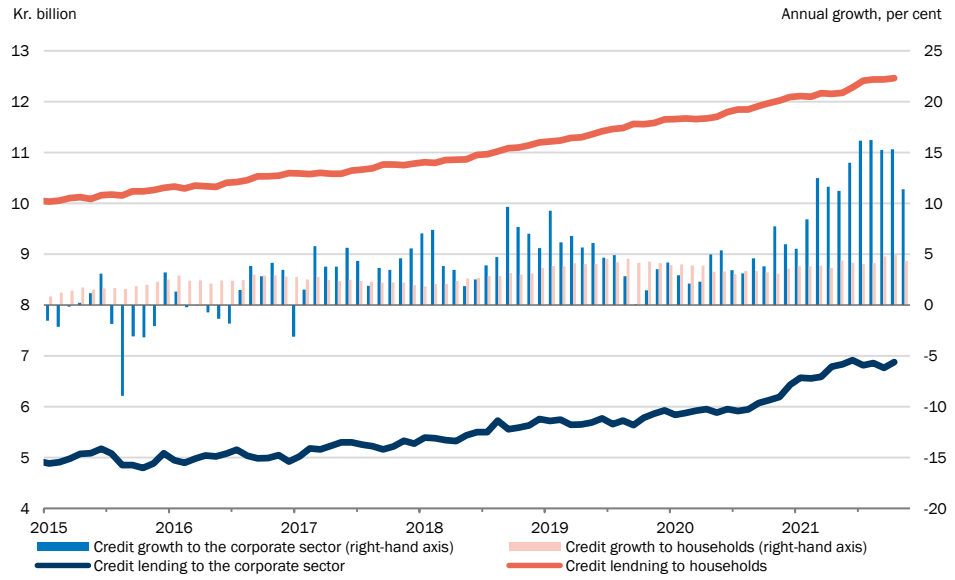
**The banks' interest rate spread** Chart A4




Note: 3-month moving avarage. The interest spread is defined as the banks' lending rate on new lending to households and non-financial companies relative to Danmarks Nationalbank's main monetary-policy interest rate (currently the rate on certificates of deposit). The banks' lending rate is a weighted average of the rates on interest on new lending by Danish and Faroese banks. The evolution of banks´rate of interest on new lending reftects the changes in the rate of interest level, but it is also affacted by the distribution of the new credit of the month.

Source: Danmarks Nationalbank.

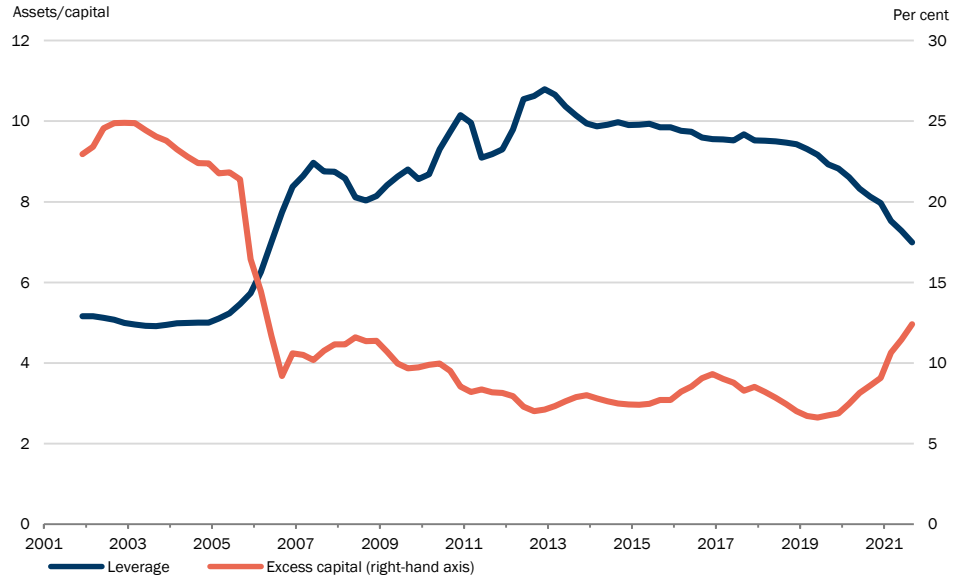
**Credit institutions' lending to the corporate sector and households in the Faroe Islands** Chart A5




Note: Credit lending from the MFI-sector to Faroese households and the Faroese corporate sector. Data include credit lending from Danish and Faroese credit institutions.

Source: Danmarks Nationalbank.

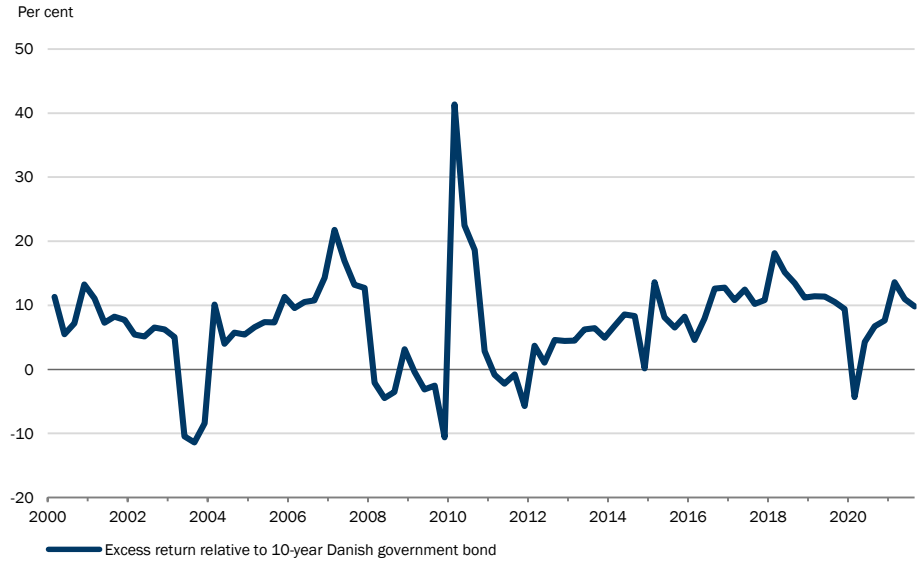
**Banks' leverage and excess capital** Chart A6




Note: Leverage is defined as the sum of assets, guarantees and commitments divided by Tier 1 capital (including Additional Tier 1 capital). In the period 2001-06, the excess capital adequacy is calculated as total capital less the individual solvency need (before 2005, the individual solvency need was set at 8 per cent). From 2007, the excess capital adequacy is calculated as the actual Common Equity Tier 1 (CET 1) less the CET1 requirement (including capital buffers). Weighted average (for the whole period).

Source: Danish Financial Supervisory Authority.

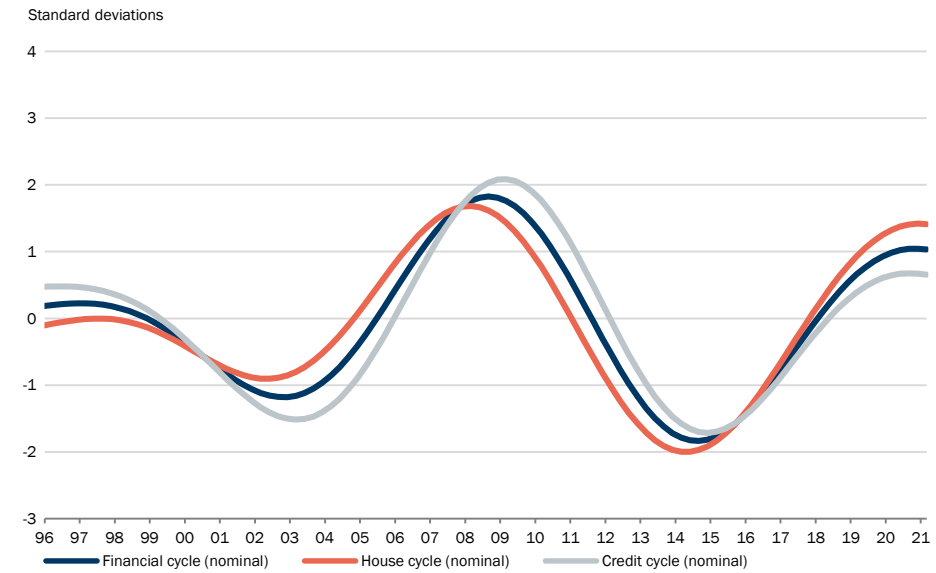
**Banks´return on equity** Chart A7




Note: Banks' return on equity (weighted average) less the current Danish 10-year government bond yield. Banks' return on equity is annualized.

Source: Danish Financial Supervisory Authority and Nordea Analytics.

**Financial cycle** Chart A8




Note: The financial cycle is based on series for nominal credit and house prices. The credit series is "Credit from Faroese banks, financial data"(cf. the note in the sheet "Credit-to-GDP"), and house prices are the annual avarage house-price in Tórshavn. The underlying series are standardised before the overall financial cycle is calculated using a principal component analysis. As a result of standardisation, an interpretation cannot be ascribed to the value of the cycle, but it reflects the phase of the cycle. The trend and the cyclic compenent are calculated with a band pass-filter, cf. Drehmann et al. (2012), Characterising the financial cycle: don't lose sight of the medium term!, BIS Working Papers, No 380, June.

Source: Danish Financial Supervisory Authority, Danmarks Nationalbank and Hagstova Føroya.

# Appendix B: Effect on other countries

## Foreign institutions must also meet a Faroese buffer

Foreign institutions with credit exposures on the Faroese Islands must also comply with a countercyclical capital buffer requirement for their Faroese exposures. Countercyclical capital buffer rate reciprocation is mandatory for the EU member states up to 2.5 per cent.[11] Reciprocity means that relevant authorities across countries recognise each other's measures, so that identical requirements are imposed on the institutions.

## No negative effects in other countries of a higher buffer on the Faroese Islands

According to the European Systemic Risk Board, macroprudential authorities must assess possible cross-border effects of macroprudential measures. The Council's approach to assessing the effects is described in the memo *Reciprocation of macroprudential measures* posted on the Council's website [link].

The Council assesses that the Faroese institutions will not significantly change their lending abroad as a result of an increase in the countercyclical capital buffer rate to 1.0 per cent on the Faroese Islands. The Faroese institutions predominantly have exposures to the Faroese economy. One single institution has some exposures to the Greenland economy. The Council's assessment is based on a number of factors, including experience from the build-up of the general systemic capital buffer rate for exposures on the Faroe Islands.

A macroprudential measure is generally expected to have positive consequential effects on other countries. A lower risk of systemic risks materialising on the Faroe Islands also reduces the risk of rub-off on other countries exposed to the development on the Faroe Islands. However, there may also be negative impacts. For example, a stricter requirement on the Faroe Islands may result in Faroese banks increasing their risk-taking in other countries if they want to pursue a higher risk profile than what is permitted by the stricter requirement on the Faroese Islands. This may contribute to reducing credit standards and result in the build-up of risks in other countries if those countries are in an expansion phase.

The Danish banks generally have low exposure to the Faroese economy. A few of the Danish mortgage credit institutions have larger exposures, seen in relation to the size of the Faroese economy. All of these will have to reciprocate a countercyclical capital buffer rate of 1 per cent on their Faroese exposures. However, the effect on the capital adequacy requirement for the Danish institutions will be limited, as the Faroese exposures constitute a minor share of the total exposures.

[11] The same applies to countries with which the EU has entered into agreements in the financial area.