DET SYSTEMISKE RISIKORÅD

Increase in the systemic risk buffer rate of the Faroe Islands

The Systemic Risk Council recommends to the Minister for Industry, Business and Financial Affairs that the systemic risk buffer rate for exposures in the Faroe Islands be increased to 3 per cent from 1 July 2025.

The Systemic Risk Council, the Council, is responsible for identifying and monitoring systemic financial risks in the Faroe Islands and can recommend macroprudential measures related to the banks of the Faroe Islands.[1] The purpose of the systemic risk buffer is to make banks more resilient to large fluctuations in the Faroese economy.

To ensure a level playing field for Faroese and foreign banks with exposures in the Faroe Islands, the Council recommends that the Minister request authorities in other relevant countries to recognise the systemic risk buffer rate for the Faroese risk exposures.[2]

The Minister for Industry, Business and Financial Affairs is responsible for determining the systemic risk buffer rate for the Faroe Islands. The Minister for Industry, Business and Financial Affairs is required, within a period of three months, to either comply with the recommendation or to present a statement explaining why the recommendation has not been complied with.

Grounds

In April 2024, the Council received an opinion from the Faroese Systemic Risk Council, Føroya Váðaráð, stating that the systemic risk buffer should be 3 per cent in light of the structural systemic risks in the Faroese economy.

The Faroese economy is small and open with a concentrated business structure heavily dependent on fisheries and fish farming. This makes the economy vulnerable to negative economic shocks which, through direct and indirect effects, may lead to losses in the banking sector and amplify fluctuations in the real economy. Historically, there have been major fluctuations in the Faroese economy and with marked variation in the loan impairment charges in Faroese banks. The overall assessment is that the Faroese financial sector is vulnerable to the structural factors that characterise the Faroese economy, see also Appendix A.

The systemic risk buffer was activated in 2018 to address structural systemic risks in the Faroese economy. The buffer was gradually built up to a level of 3 per cent from 1 January 2020. However, it was reduced from 3 to 2 per cent in March 2020 in response to the uncertainty and challenges associated with the spread of Covid-19.

---

1 The Faroese Systemic Risk Council was established in 2018. The council may issue observations, warnings and recommendations concerning Faroese areas of responsibility. 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 Appendix C for details.

The systemic risk buffer addresses structural systemic risks. There are also cyclical systemic risks in the Faroe Islands, which are addressed by the countercyclical capital buffer, currently at 1 per cent.

Expected effects

The increase in the systemic risk buffer is expected to increase the capitalisation of banks so that they are better able to withstand negative economic shocks, including the ability to continue lending to sound projects. This helps to ensure financial stability in the Faroe Islands.

The Faroese banks will be able to meet the requirement for a systemic risk buffer rate of 3 per cent with their current capital level in line with other requirements being phased in, see Appendix B. In addition, it is easier for banks to increase their capital during periods of economic upswing and positive profit, as in the current situation.

The requirement for banks to maintain a systemic risk buffer is not mandatory. Which means that non-compliant banks will not lose their licence to operate. Banks will instead be required to submit a capital conservation plan to the Danish Financial Supervisory Authority, and there may be restrictions on the payment of bonuses and dividends if they do not comply with the combined capital buffer requirement.[3]

The systemic risk buffer was introduced into financial regulation after the financial crisis as part of a wide-ranging set of reforms aimed at making the financial sector more resilient. The systemic risk buffer is also used in other countries, see Appendix C.

Christian Kettel Thomsen, Chairman of the Systemic Risk Council

Statement from the representatives of the ministries on the Council

"The representatives of the ministries and the Danish Financial Supervisory Authority do not have the right to vote on recommendations addressed to the government.

The government will request the Faroese government for an assessment of the recommendation with a view to an overall assessment of whether there is a basis 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."

[3] In addition to the systemic risk buffer, the combined capital buffer requirement consists of the capital conservation buffer and the countercyclical capital buffer.

Appendix A: Background to the recommendation to increase the systemic risk buffer rate

This appendix elaborates on the vulnerabilities in the financial system resulting from the structural conditions prevalent in the Faroese economy.

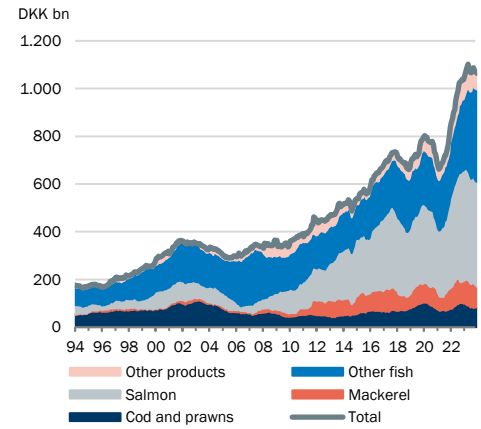
The Faroese economy is heavily dependent on aquaculture and fishing

The fishing and aquaculture industries are crucial for income and employment opportunities in the Faroe Islands, although the service industries have become increasingly important in recent years. Fishing and aquaculture accounted for approximately one fifth of the total gross value added in the Faroe Islands in 2022. There are also related industries such as the fish processing industry.

The value of seafood has accounted for over 90 per cent of goods exports for a number of years, see chart A1 (left). The share of farmed salmon has been increasing since 2006 and accounted for some 45 per cent of fish exports in 2023.

Possible risk factors for Faroese exports – and thus the economy – are plummeting fish prices, substantial reductions in stocks or disease in the farmed stocks. The fact that profits are spread across different types of fishing-related industries and that measures have been taken to prevent the spread of infection between aquaculture companies reduces the vulnerability of the economy to some extent.

Exports by fish species and geography Chart A1



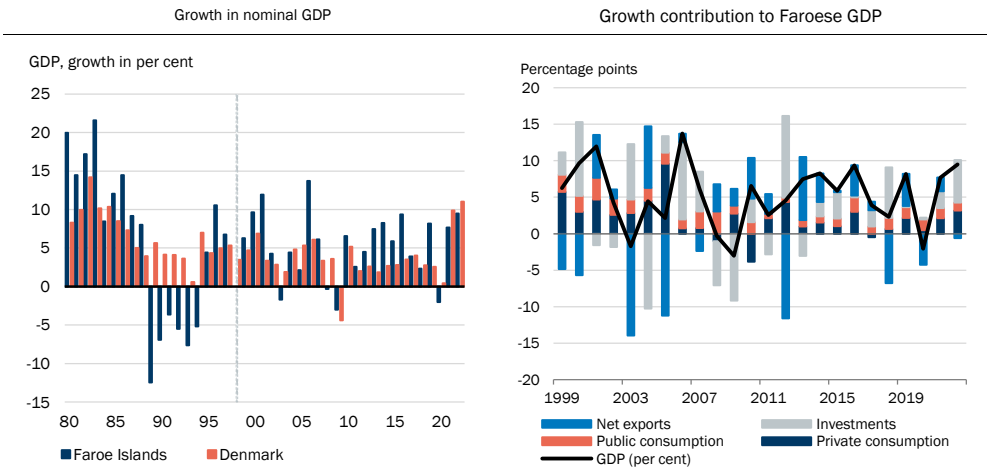
Note: Exports are based on monthly data. All series are 12-month moving averages of the actual values. Latest observation is from December 2023.

Source Hagstova Føroya.

Small, open economy with large economic fluctuations

Because the Faroese economy is small and open and has a concentrated business structure, economic fluctuations can be significant. This has also been shown historically, see chart A2 (left). A breakdown of growth contributions to GDP shows that there is significant variation in the different components, especially for net exports and investments, see chart A2 (right).

Development in GDP Chart A2



Note: Current prices. Data breaks for Faroese data in 1998, see the dotted line in the chart to the left.
Source Statistics Denmark, Hagstova Føroya and own calculations.

Financial implications can be significant

A negative shock can spread quickly in a small, open economy like that of the Faroe Islands. As the economy relies heavily on fishing and aquaculture, a negative shock to these industries will also affect other parts of the economy, including related industries and the banking sector.

If the households and businesses affected are unable to pay back their loans, banks will suffer losses. Current lending to "Fisheries, aquaculture, etc." by Faroese banks accounts for 16 per cent of total corporate lending, see chart A3 (left). However, as this industry is so important to others, risks related to fishing and aquaculture will be higher than direct lending would suggest. Furthermore, second-round effects via lower incomes and resultant lower economic activity will increase the risk of losses for banks. When fluctuations in the economy are large, potential losses for banks can also be large.

Wide variation in bank impairment charges

Historically, the fluctuations in bank impairment charges have been large, see chart A3 (right).

The Faroese crisis in the early 1990s was very extensive. In 1992-93, about half of bank loans were impaired.[4] A contributing factor was a sharp drop in catches and fish prices, which meant that ships, factories and banks were forced into liquidation, among other things.

The high impairment charges in 2003 should be seen partly in light of the fact that the aquaculture industry was under pressure as a result of low salmon prices on the world market and salmon diseases.[5] Impairment charges on loans and guarantees for fisheries accounted for approximately 20 per cent of the total impairment charge rate of 4.8 per cent.[6]

[4] In the 1990s, it wasn't impairment charges, but provisions. Banks had to make provisions of kr. 4 billion in 1992-93, corresponding to half of the book value of loans and guarantees. Of the total provisions of kr. 4.9 billion, 3.5 billion had to be written off as losses, while 1 billion could be reversed, cf. Astrup Hansen, Færøerne – fra planøkonomi til markedsøkonomi, (the Faeroe Islands – from planned economy to social economy) *Samfundsøkonomen*, DJØF, no. 1, April 2017.

[5] After 2001, a combination of disease and sharply falling market prices led to major losses in the aquaculture industry, cf. *Report 2004*, Ombudsman of the Faroe Islands.

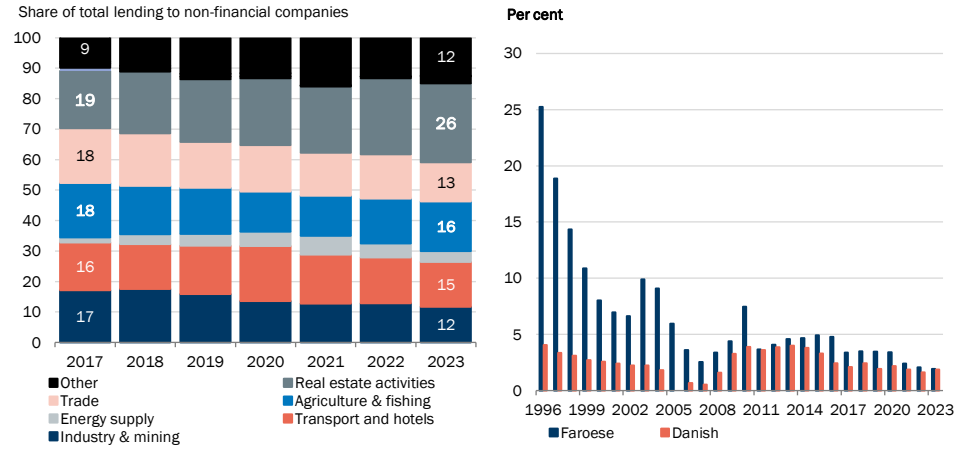
[6] See data from the Danish Financial Supervisory Authority.

However, the proportion of impairment charges related to aquaculture may be higher as parts of other industries are linked to it.

Loan impairment charges in the most recent period after the global financial crisis are spread more broadly across different industries.

Corporate lending and impairment charges Chart A3

Lending to the corporate sector by industry | Impairment charges in Faroese and Danish banks



Note: *Left:* Loans to non-financial companies by industry. Loans from Faroese banks, Danish banks and mortgage banks and mortgage credit institutions are included. Year-end data.
Right: The figure shows the accumulated impairment charge losses of Faroese and Danish institutions as a percentage of loans and guarantees. Please note that the Danish banking sector is not directly comparable to the Faroese banking sector, but helps to give a picture of the size of impairment charges.

Source Danmarks Nationalbank, Hagstova Føroya and own calculations.

Appendix B: Capital ratios and other requirements of the banks

The Council includes other policy measures in its deliberations on the systemic risk buffer rate, including the phasing-in of other requirements, such as the MREL requirement.

The MREL requirement is a requirement for institutions' eligible liabilities (MREL).[7] However, the purpose of the MREL differs from the purpose of the systemic risk buffer. The MREL is intended to ensure that institutions can be restructured or resolved without the use of government funds and without a significant negative impact on financial stability. The MREL requirement can be met with several types of capital and debt instrument, while the buffer requirements can only be met with CET1 capital.

Given their current capital levels, Faroese banks will be able to meet the requirement to increase the systemic risk buffer rate to a level of 3 per cent while phasing in other requirements.

[7] The MREL requirement concerns eligible liabilities that can absorb losses and recapitalise an institution in a liquidation situation.

Appendix C: Effects in other countries

The Council recommends that other relevant countries recognise the 3 per cent systemic risk buffer rate for all Faroese risk exposures. Besides ensuring a level playing field for Faroese and foreign banks, this will also enhance the resilience of foreign banks to structural risks in the Faroe Islands. The measure can therefore have a positive effect in countries that have banks with significant exposures in the Faroe Islands.[8]

It is voluntary for authorities in other countries to recognise the systemic risk buffer rate. Where authorities in other countries acknowledge the requirement, institutions with very small Faroese exposures may be exempted from this requirement. To this end, the Council recommends an absolute institution-specific limit of DKK 200 million.

A systemic risk buffer is also used in other countries

Iceland and Norway are examples of countries that apply the buffer to all domestic exposures.[9] Both countries are open economies where unforeseen negative shocks can develop quickly and strongly. The systemic risk buffer rate is set at 4.5 per cent in Norway and 3 per cent in Iceland.

[8] However, the effect is expected to be small, as the exposures of foreign banks in the Faroe Islands represent a modest share of their total exposures.

[9] For *Norway*: Notification to the ESRB on the use of the systemic risk buffer and " A framework for advice on the systemic risk buffer", 2022. For *Iceland*: "Recommendations to the Financial Supervisory Authority to introduce a capital buffer for systemically important financial institutions, a systemic risk buffer, and a countercyclical capital buffer", Financial Stability Council, 22 January 2016, and "Recommendation concerning a systemic risk buffer: rationale", Financial Stability Council, 22 January 2016.