DET SYSTEMISKE RISIKORÅD

9 April 2018

Recommendation

Increase of the systemic risk buffer rate in the Faroe Islands

The Systemic Risk Council recommends that the Minister for Industry, Business and Financial Affairs raise the general part of the systemic risk buffer rate to 2 per cent for exposures in the Faroe Islands with effect from 1 January 2019 and to 3 per cent from 1 January 2020.

It is the task of the Systemic Risk Council, the Council, to identify and monitor systemic financial risks in the Faroe Islands, and the Council may make recommendations on macroprudential measures concerning banks in the Faroe Islands.[1] The purpose of the general systemic risk buffer is to make the banks more resilient to strong fluctuations in the Faroese economy.

The Minister for Industry, Business and Financial Affairs is responsible for setting the systemic buffer rate for the Faroe Islands. In accordance with the Council's recommendation of March 2017, the Minister has set a general systemic risk buffer rate of 1 per cent for exposures in the Faroe Islands from 1 January 2018. The present recommendation follows up the March 2017 recommendation in which the Council assessed that the buffer rate should be raised further over the coming years.[2] The Faroese Systemic Risk Council has been involved in the Council's discussion of the buffer rate.

With a view to ensuring a level playing field for Faroese and foreign banks with exposures in the Faroe Islands, the Council still advises the Minister to request the authorities in other relevant countries to acknowledge the systemic risk buffer rate for Faroese risk exposures.[3]

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.

Explanatory statement

The Faroese economy is a small, open economy with a concentrated business structure heavily dependent on fisheries and aquaculture. This makes the economy vulnerable to negative economic shocks, which may, via direct and indirect effects, entail losses in the banking sector and amplify real economic fluctuations. Historically, the Faroese economy has fluctuated strongly, with marked variation in the loan impairment charges of the Faroese banks. The Council still finds that the Faroese financial sector is vulnerable to the structural factors characterising the Faroese economy, cf. Appendix A.

The Council finds that the systemic risk buffer for the Faroe Islands can address these vulnerabilities. The aim of the systemic risk buffer is to prevent and

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1 A Systemic Risk Council was established in the Faroe Islands in early 2018. It can issue observations, warnings and recommendations concerning Faroese areas of responsibility. As regards Danish areas of responsibility in the financial area, the Faroese Systemic Risk Council may issue opinions to the Systemic Risk Council in Denmark.

2 The recommendation is available here: http://www.risikoraad.dk/media/1125/recommendation_-_activation_of_the_systemic_risk_buffer_in_the_faroe_islands.pdf

3 See Appendix C for more details.

mitigate structural vulnerabilities. The buffer increases the banks' capitalisation, thereby enhancing their resilience to negative economic shocks. This contributes to ensuring financial stability in the Faroe Islands.

Given their current capitalisation and the phasing-in of other capital buffer requirements, most Faroese banks will be able to meet the requirement for a general systemic risk buffer rate of 3 per cent, cf. Appendix B. Moreover, it is easier for the banks to increase their capitalisation in periods of economic recovery and positive earnings, as in the current situation. The smallest Faroese bank will have to increase its capital ratio.

The requirement that the banks must maintain a systemic risk buffer is not a "hard" requirement. So banks in breach of the requirement will not lose their banking licences. Instead, they will be required to submit a capital conservation plan to the Danish Financial Supervisory Authority, and bonus and dividend payments etc. may also be limited if the banks fail to comply with the combined capital buffer requirement.[4] As regards systemically important financial institutions, SIFIs, the general systemic risk buffer rate will be an add-on to the SIFI requirements, which are to be phased in by 2019.

The systemic risk buffer was introduced in financial regulation after the financial crisis as part of a larger set of reforms aiming to make the financial sector more robust. The systemic risk buffer is also used in other countries, cf. Appendix C.

Lars Rohde, Chairman of the Systemic Risk Council

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 government representatives on the Council. Neither the government representatives 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."

[4] In addition to the systemic risk buffer, the combined capital buffer requirement comprises the capital conservation buffer and the countercyclical capital buffer, cf. Executive Order no. 1349 of 12 December 2014 on calculation of the combined buffer requirement, the maximum distributable amount and the content of a capital conservation plan for certain financial enterprises and the Danish Financial Supervisory Authority's memo, "Bestemmelser om kapitalbevaringsplan og opgørelse af det maksimale udlodningsbeløb" (Provisions on a capital conservation plan and calculation of the maximum distributable amount) at the Danish Financial Supervisory Authority's website.

Appendix A: Background to the recommendation to raise the general systemic risk buffer rate

This Appendix elaborates on the vulnerabilities in the financial system resulting from the structural factors characterising the Faroese economy.

The Faroese economy is heavily dependent on aquaculture and fisheries

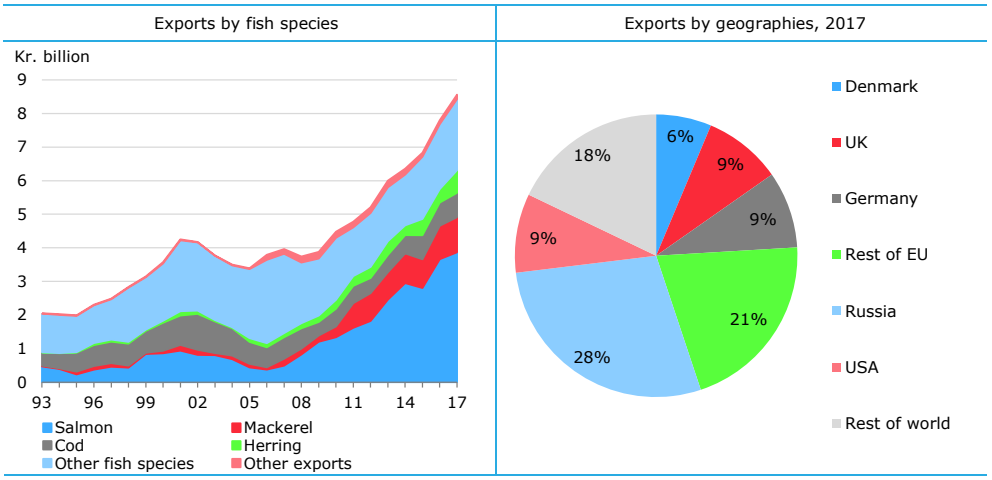
The fisheries and aquaculture sectors are paramount to income and employment opportunities in the Faroe Islands, although the service sectors are gaining ground. Fisheries and aquaculture accounted for around one fifth of total gross value added in the Faroe Islands in 2015.[5] To this should be added related industries such as fish processing.

In value terms, fish and shellfish have accounted for more than 95 per cent of goods exports for many years, cf. Chart A1 (left). The share of farmed salmon has been increasing since 2006 and accounted for 46 per cent of fish exports in 2017.[6]

Russia is the largest export market of the Faroe Islands, cf. Chart A1 (right). One reason is that the Faroe Islands are not comprised by Russia's trade embargo against the EU and other western countries which have introduced sanctions against Russia.[7] The USA is the second largest market outside the EU. US demand for Faroese farmed salmon took off when widespread disease broke out in farmed stocks in Chile.[8]

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 measures to prevent contagion across fish farms and the diversification of earnings across different branches of fisheries to some extent help to reduce the vulnerability of the economy.

Exports by fish species and geographies — Chart A1



Note: *Left-hand* chart: Value of total exports, excluding ships and aircraft. The most recent observation is from 2017.
Right-hand chart: Value of total exports.

Source: Hagstova Føroya.

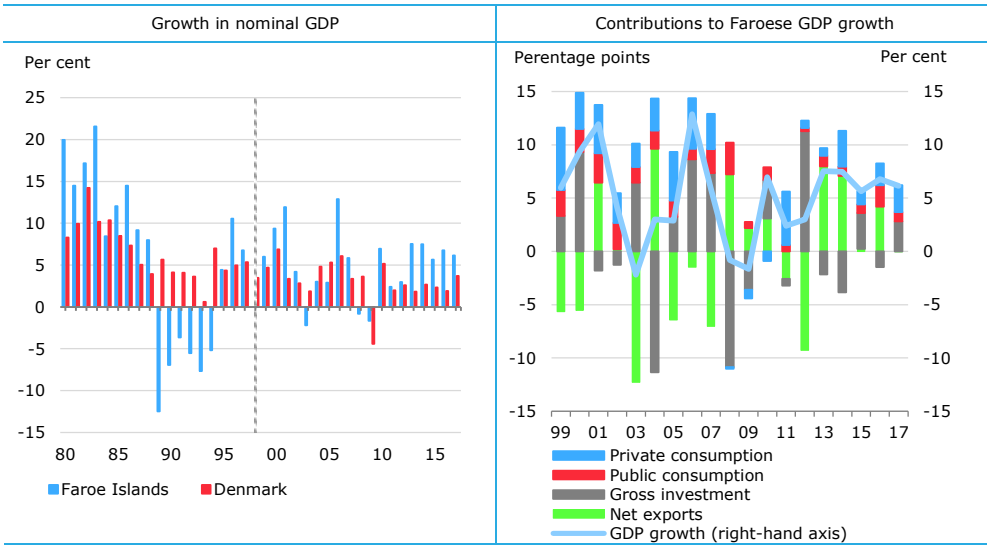
Small, open economy with strong fluctuations

Given that the Faroese economy is a small, open economy with a concentrated business structure, it may be prone to considerable economic fluctuations, as

[5] Gross value added by industry is available only until 2015, the most recent year for which final national accounts figures are available for the Faroe Islands.
[6] In volume terms, the share of salmon increased from 3 per cent of fish exports in 2006 to 13 per cent in 2017.
[7] In 2013, Faroese exports to Russia accounted for 11 per cent, compared with 28 per cent in 2017.
[8] This also contributed to a significant increase in salmon prices. Cf. *Report 2016*, High Commissioner of the Faroe Islands.

evidenced historically, cf. Chart A2 (left).[9] A compilation of the contributions to GDP growth shows substantial variation in the various components, especially net exports and investment, cf. Chart A2 (right).

Development in GDP — Chart A2



Note: Current prices. Data breaks for Faroese data in 1998, cf. the broken line in the left-hand chart. 2016 and 2017 are estimates from Hagstova Føroya.

Source: Statistics Denmark and Hagstova Føroya.

The financial implications may be considerable

A negative shock can spread rapidly in a small, open economy like that of the Faroe Islands. Given the economy's pronounced dependence on fisheries and aquaculture, a negative shock to these sectors may also have an impact on other parts of the economy, including related industries and the banking sector. The banks will suffer losses if the firms in question are unable to service their loans. Faroese banks' current lending to "fisheries, aquaculture, etc." accounts for 19 per cent of total corporate lending, cf. Chart A3 (left). Since this industry is key to other industries, risks related to fisheries and aquaculture will be higher than indicated by direct lending, however. Moreover, derived effects via lower incomes and resultant lower economic activity will increase the banks' risk of losses. Large economic fluctuations may lead to large potential losses for the banks.

Great variation in the banks' loan impairment charges

Before realising losses, the banks must – if there is objective evidence of impairment – recognise impairment charges on loans. Historically, the banks' loan impairment charges have fluctuated strongly, cf. Chart A3 (right).

The negative loan impairment charges, i.e. reversals, in the second half of the 1990s should be viewed in the light of the preceding large loan impairment charges in the crisis years in the early 1990s. In 1992-93, impairment charges were made for almost half of the banks' lending.[10] The Faroese crisis in the early 1990s was extensive. One reason was considerable falls in catch volumes and fish prices, which meant that ships, factories and banks went out of business.

The large loan impairment charges in 2003 should be viewed against the backdrop of pressure on the aquaculture industry due to low salmon prices in

[9] The Faroese GDP is compiled in current prices only, meaning that price developments in foreign markets impact the development in GDP. For example, salmon prices have soared since 2013, while oil prices have fallen. This has benefited the Faroese terms of trade. See also *Report 2017*, High Commissioner of the Faroe Islands.

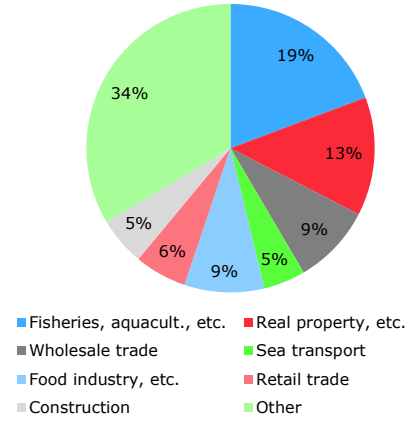
[10] In the 1990s, the issue was not loan impairment charges, but provisions. In 1992-93, the banks had to make provisions of kr. 4 billion, corresponding to half of the book value of loans and guarantees. Out of the total provisions of kr. 4.9 billion, an amount of kr. 3.5 billion subsequently had to be written off as losses, while kr. 1 billion could be reversed, cf. Astrup Hansen (2017), Færøerne – fra planøkonomi til markedsøkonomi *(Faroe Islands – from planned economy to market economy – in Danish only), Samfundsøkonomen*, DJØF, No. 1, April.

the world market and salmon disease.[11] Loan impairment charges on loans and guarantees for fisheries accounted for approximately 20 per cent of the total loan impairment charge ratio of 4.8 per cent.[12] The share of loan impairment charges related to aquaculture may be larger, however, as parts of other industries are linked to aquaculture.

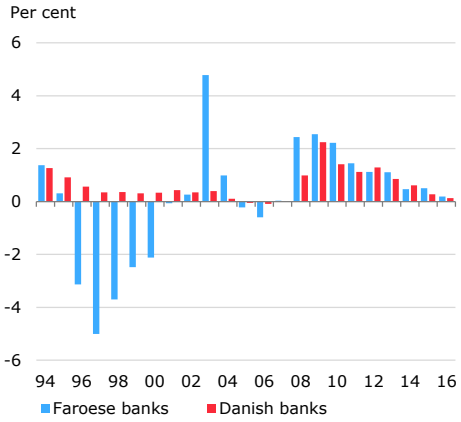
Loan impairment charges in the most recent period, in the wake of the global financial crisis, are distributed more broadly on different industries.

Lending to the corporate sector and loan impairment charges — Chart A3

Lending to the corporate sector by industry, January 2018



Loan impairment charges in Faroese banks



Note: *Left-hand* chart: Lending by Faroese banks to non-financial corporations in the Faroe Islands, January 2018.
Right-hand chart: Impairment charges as a percentage of loans and guarantees. The data before 2005 covers provisions. It should be noted that although the Danish and Faroese banking sectors are not directly comparable, the Danish banking sector helps to put the size of the loan impairment charges into perspective.

Source: Danish Financial Supervisory Authority and Danmarks Nationalbank.

[11] After 2001, a combination of disease and plummeting market prices generated large losses in aquaculture, cf. *Report 2004*, High Commissioner of the Faroe Islands.
[12] Cf. data from the Danish Financial Supervisory Authority.

Appendix B: The banks' capitalisation

Given their current capitalisation and the phasing-in of other capital buffer requirements, most Faroese banks will be able to meet the requirement for an increase of the systemic risk buffer rate by 2 percentage points to a level of 3 per cent, cf. Table B1. The smallest Faroese bank will have to increase its capital ratio, however.

Three out of four Faroese banks have been classified as systemically important financial institutions, SIFIs. As regards SIFIs, the general systemic risk buffer rate will be an add-on to the SIFI requirements, which are to be phased in by 2019 and depend on the banks' systemic importance.

Excess capital adequacy, end-2017 — Table B1

Per cent of risk exposures	BankNordik	Betri	Nordoya	Suduroyar
Solvency ratio	19.8	26.2	19.2	15.4
Common Equity Tier 1 ratio	17.5	26.2	17.2	13.9
Individual capital need	9.0	11.5	9.6	10.3
Buffer requirement 2018	4.0	4.4	4.0	2.8
Buffer requirement 2019	5.0	5.4	5.0	3.5
Excess capital adequacy 2018	6.7	10.4	5.5	2.4
Excess capital adequacy 2019	5.7	9.4	4.6	1.8

Note: The buffer requirements are the capital conservation buffer and the systemic risk buffer including SIFI requirements. The buffer requirements will be phased in until 2019. Excess capital adequacy has been calculated under the assumption of unchanged capital ratios and Pillar II add-ons.

Kilde: Danish Financial Supervisory Authority.

The Council also takes other policy measures into account in its considerations about the systemic buffer rate, including the phasing-in of future capital buffer requirements by 2019. Another future requirement for the institutions is the MREL (Minimum Requirement for Eligible Liabilities).[13] However, the purpose of the MREL is different from the purpose of the systemic risk buffer. The MREL is to ensure that institutions can be restructured or resolved without the use of government funds, without such resolution having any substantial negative impact on financial stability. The MREL may be met using several types of capital and debt instruments, whereas the buffer requirements can be met using Common Equity Tier 1 capital only.

[13] Eligible liabilities can absorb losses and recapitalise an institution in a resolution situation.

Appendix C: Effects in other countries

Raising the general part of the systemic risk buffer rate by 2 percentage points is not expected to induce the Faroese banks to increase their foreign lending to any notable extent. Given the modest volume of Faroese foreign exposures, the proposed measure is not assessed to have any effect on financial stability outside the Faroe Islands.

The Council advises other relevant countries to acknowledge the general systemic risk buffer rate of 3 per cent for all Faroese risk exposures. Besides ensuring a level playing field for Faroese and foreign banks, this will also enhance foreign banks' resilience to structural risks in the Faroe Islands. The measure may thus have a positive effect in countries with banks holding considerable exposures to the Faroe Islands.[14]

Given that the Faroe Islands are outside both the EU and the EEA, it is voluntary for other countries to acknowledge the systemic 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 kr. 200 million, or 1 per cent of total lending, including lending from abroad, in the Faroe Islands.

The systemic buffer is also used in other countries

Iceland and Estonia are examples of countries applying the systemic buffer rate to all domestic exposures.[15] Both are small, open economies where unexpected negative shocks may spread quickly and strongly. The systemic buffer rate is 1 per cent in Estonia and 3 per cent in Iceland. In both countries, systemically important financial institutions are also subject to a separate capital requirement.[16]

[14] However, the effect is expected to be small, as foreign banks' exposures in the Faroe Islands constitute a modest share of those banks' total exposures.

[15] For *Estonia*: Notification to the ESRB on the application of the systemic risk buffer and "Systemic risk buffer and other systemically important institutions buffer, Analysis of the setting of the buffer requirements in Estonia", April 2016.
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.

[16] The SIFI requirements in Estonia and Iceland have been implemented by applying another capital buffer: the O-SII ("Other Systemically Important Institutions") buffer, which is specifically targeted at SIFIs, while the systemic buffer can be applied more broadly. The O-SII buffer, with a ceiling of 2 per cent under EU regulation, has not been implemented in Danish and Faroese legislation.