DET SYSTEMISKE RISIKORÅD

30 March 2017

Recommendation

Activation of the systemic risk buffer in the Faroe Islands

The Systemic Risk Council *recommends* that the Minister for Industry, Business and Financial Affairs set a general systemic risk buffer rate of 1 per cent for exposures in the Faroe Islands from 1 January 2018.

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

The Council assesses that the buffer rate should be further increased in the coming years. The Council will involve the Faroese authorities in the discussion of a suitable risk buffer rate level and the time horizon for phasing in the buffer rate to this level.

With a view to ensuring a level playing field for Faroese and foreign banks with exposures in the Faroe Islands, the Council advises the Minister to request authorities in other relevant countries to reciprocate the systemic risk buffer rate of 1 per cent for all Faroese risk exposures.[2]

The government 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 assesses that the Faroese financial sector is vulnerable to the structural factors characterising the Faroese economy, cf. Appendix 1.

The Council finds that activation of the systemic risk buffer for the Faroe Islands can address these vulnerabilities. The aim of the buffer is to prevent and mitigate structural systemic financial risks. The buffer increases the banks' capitalisation, thereby enhancing their resilience to negative economic shocks. This contributes to ensuring financial stability in the Faroe Islands.

The Faroese banks are assessed to be able to meet a systemic risk buffer requirement of 1 per cent, given their current capitalisation. In addition, it is easier for the banks to increase their capitalisation in periods of economic recovery and positive earnings, as in the current situation.

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1 In 2016, it was decided to establish a Systemic Risk Council in the Faroe Islands. 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 Danish Systemic Risk Council.

2 Authorities in other countries may exempt institutions with very small Faroese exposures from this requirement. To this end, the Council recommends an institution-specific limit of kr. 200 million, i.e. 1 per cent of total lending, including lending from abroad, in the Faroe Islands.

The requirement that the banks must maintain a systemic risk buffer is not a "hard" requirement. Consequently, 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.[3]

As regards systemically important financial institutions, SIFIs, the general systemic buffer rate will be an add-on to the SIFI requirements, which are to be phased in by 2019, cf. the Appendix. The Minister for Industry, Business and Financial Affairs is responsible for setting the systemic risk buffer rate.

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

Lars Rohde, Chairman of the Systemic Risk Council

Statements from the representatives of the ministries on the Council

The Council has analysed the Faroese economic structures and interaction with the Faroese financial sector and has received input from the Faroe Islands. The Faroese economy has a concentrated business structure closely linked to fisheries and aquaculture. As the Faroese economy is a small, open economy, negative shocks to this industry and related industries may rapidly spill over to the whole Faroese economy.

The risk buffer is intended to make the Faroese credit institutions more resilient to losses, thereby enhancing their robustness against any potential future economic shocks. The purpose of activating the risk buffer is not to influence cyclical developments in the Faroe Islands.

The representatives of the ministries agree that it would be appropriate initially to set the systemic risk buffer rate for the Faroe Islands at 1 per cent from 1 January 2018.

[3] In addition to the systemic risk buffer, the combined capital buffer requirement comprises the capital conservation buffer and the countercyclical capital buffer, cf. "Bekendtgørelse om opgørelse af det kombinerede kapitalbufferkrav mv." (Executive Order on Calculation of the Combined Capital Buffer Requirement etc.) issued by the Danish Financial Supervisory Authority on 16 December 2014 and the related memo, "Bestemmelser om kapitalbevaringsplan og opgørelse af det maksimale udlodningsbeløb" (Provisions on a capital conservation plan and calculation of the maximum distributable amount) on the Danish Financial Supervisory Authority's website.

Appendix 1: Background

This Appendix describes the background to the Council's recommendation of a systemic risk buffer rate of 1 per cent for exposures in the Faroe Islands.

The Faroese economy is heavily dependent on aquaculture and fisheries

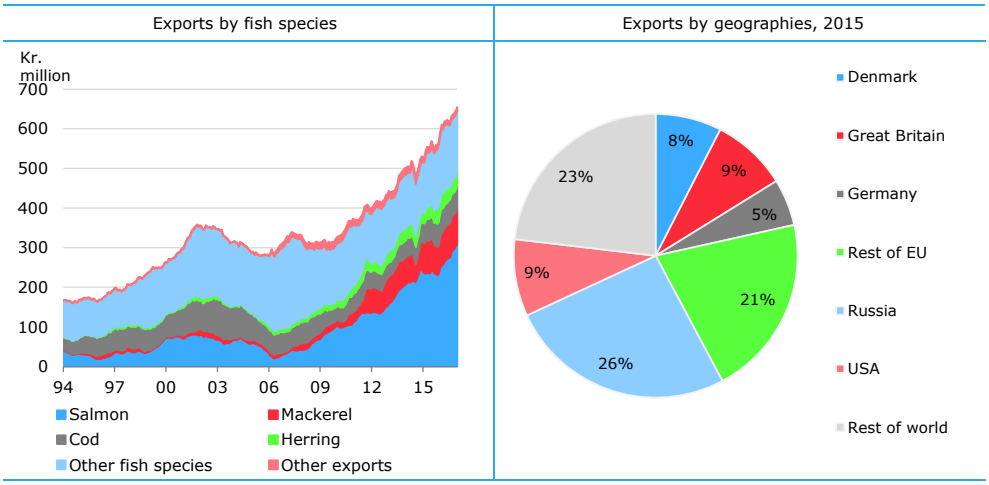
The fisheries and aquaculture sectors are paramount to income and employment opportunities in the Faroe Islands, although the service sectors are gaining ground. Fisheries and aquaculture accounted for around one sixth of total gross value added in the Faroe Islands in 2013.[4] To this should be added related industries such as fish processing. A breakdown of wage expenditures by main sectors shows that fisheries, aquaculture and processing as well as other fish-related industries accounted for around 20 per cent of total wage expenditures in 2016.

The value of fish and shellfish accounted for 98 per cent of goods exports, excluding ships and aircraft, in 2016, cf. Chart A.1 (left). The share of farmed salmon has increased since 2006, accounting for 48 per cent of fish exports in 2016.[5]

A geographical breakdown of total exports shows that Russia is the largest export market of the Faroe Islands, cf. Chart A.1 (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.[6] 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. This also contributed to a significant increase in salmon prices.[7]

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 overall.

Exports by fish species and geographies — Chart A.1



Note: *Left-hand* chart: Exports excluding ships and aircraft. 12-month moving averages of export values. The most recent observations are from January 2017.
Right-hand chart: Value of total exports.

Source: Hagstova Føroya.

4 Gross value added by industry is available only until 2013, the most recent year for which final national accounts figures are available for the Faroe Islands. From 2014, estimates are available for the main series, but no breakdown by industry.

5 In volumes, the share of salmon increased from 3 per cent of fish exports in 2006 to 13 per cent in 2016.

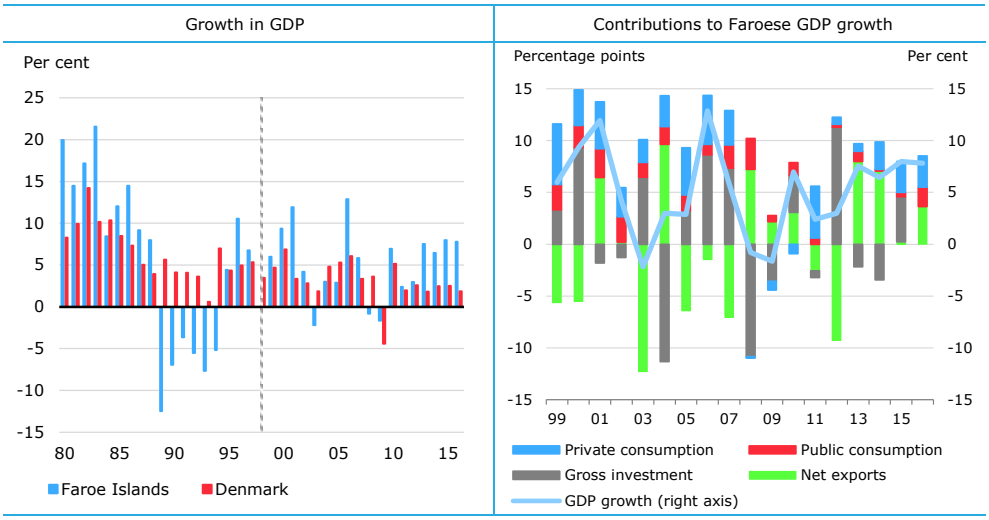
6 In 2013, Faroese exports to Russia accounted for 11.5 per cent, compared with 25.9 per cent in 2015.

7 Cf. *Report 2016*, High Commissioner of the Faroe Islands.

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 evidenced historically, cf. Chart A.2 (left).[8] A compilation of the contributions to GDP growth shows substantial variation in the various components, especially net exports and investment, cf. Chart A.2 (right).

Development in GDP — Chart A.2



Note: Current prices. Data breaks for Faroese data in 1998, cf. the broken line in the left-hand chart. 2014, 2015 and 2016 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. 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.

Marked variation in the banks' loan impairment charges

Before realising losses, the banks must – if there is objective evidence of impairment – make impairment charges on loans. Historically, the banks' loan impairment charges have fluctuated strongly, cf. Chart A.3 (left).

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.[9] 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

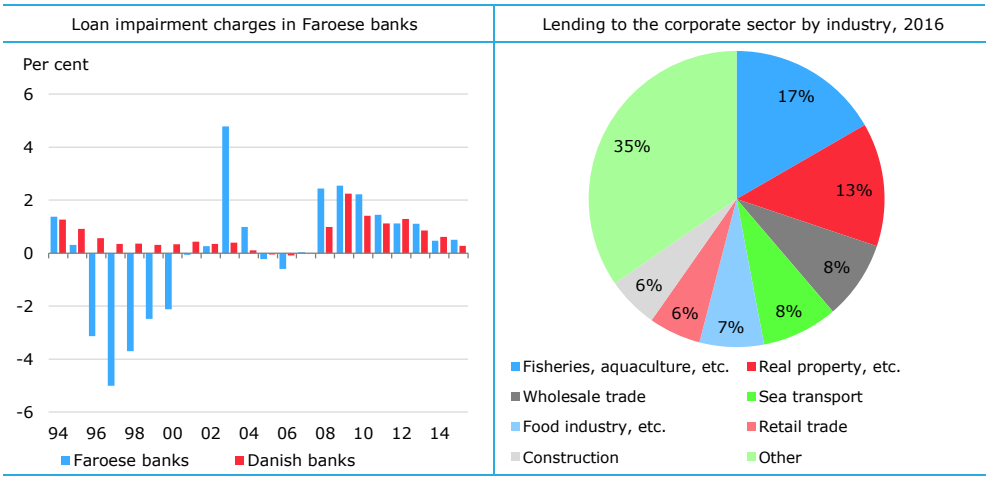
8 The Faroese GDP is compiled in current prices only, meaning that price developments in foreign markets impact the development in GDP. For example, salmon prices have soared since 2013, while oil prices have fallen. This has benefited the Faroese terms of trade. See also *Report 2016*, High Commissioner of the Faroe Islands.

9 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. *Færøerne – fra planøkonomi til markedsøkonomi* (Faroe Islands – from planned economy to market economy – in Danish only) by Jørn Astrup Hansen, Samfundsøkonomen, DJØF, April 2007, No. 1.

the world market and salmon disease.[10] Out of the loan impairment charge ratio of 4.8 per cent, loan impairment charges on loans and guarantees for fisheries accounted for approximately 20 per cent.[11] 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.

Loan impairment charges and lending to the corporate sector — Chart A.3



Note: *Left-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.
Right-hand chart: Faroese banks' lending to non-financial corporations in the Faroe Islands, December 2016.

Source: Danish Financial Supervisory Authority and Danmarks Nationalbank.

Faroese banks' current lending to "fisheries, aquaculture, etc." accounts for 17 per cent of total corporate lending, cf. Chart A.3 (right). Since this industry is key to other industries, risks related to fisheries and aquaculture will be higher than indicated by direct lending, however.

The Faroese banks are well capitalised to meet the requirement

The Faroese banks will be able to meet the systemic risk buffer requirement of 1 per cent, given their current capitalisation and the phasing-in of other capital buffer requirements, cf. Table 1. The existing capital buffer requirements, which are to be phased in by 2019, depend on the banks' systemic importance. Three out of four Faroese banks have been classified as systemically important financial institutions, SIFIs.

[10] After 2001, a combination of disease and plummeting market prices generated large losses in aquaculture, cf. *Report 2004*, High Commissioner of the Faroe Islands.

[11] Cf. data from the Danish Financial Supervisory Authority.

Excess capital adequacy, end-2016				Table 1
Per cent of risk exposures	BankNordik	Betri Banki	Nordoya	Suduroyar
Solvency ratio	18.3	25.0	19.0	15.1
Common Equity Tier 1 ratio	16.0	25.0	16.9	13.6
Individual capital need	8.8	10.2	9.2	9.8
Buffer requirement 2017	2.5	2.5	2.2	1.3
Buffer requirement 2018	3.5	3.5	3.1	1.9
Buffer requirement 2019	4.5	4.5	4.0	2.5
Excess capital adequacy 2017	6.9	12.4	7.7	4.0
Excess capital adequacy 2018	5.9	11.4	6.7	3.4
Excess capital adequacy 2019	4.9	10.4	5.8	2.8

Note: Betri Banki was formerly known as Eik Banki. The buffer requirement consists of the capital conservation buffer (for all banks) and the SIFI buffer. The buffers will be phased in until 2019. Excess capital adequacy has been calculated under the assumption of unchanged capital ratios and Pillar II add-ons.

Source: BankNordik Annnual report 2016 and Danish Financial Supervisory Authority.

This measure will have limited effects on other countries

The introduction of a systemic risk buffer rate of 1 per cent is not expected to induce the Faroese banks to increase their foreign lending to any notable extent. Since the Faroese banks' foreign exposures are modest, the proposed measure is not expected to impact financial stability outside the Faroe Islands.

The Council advises other countries to reciprocate the systemic risk buffer rate of 1 per cent for all Faroese risk exposures. Besides ensuring a level playing field for Faroese and foreign banks, it 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.[12]

The systemic risk buffer is also used in other small, open economies

Iceland and Estonia are examples of countries applying the systemic risk buffer to all domestic exposures.[13] Both are small, open economies where unexpected negative shocks may spread quickly and strongly. The 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.[14]

[12] 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.

[13] 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*: "Financial Stability Council's 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" and "Financial Stability Council's rationale for the recommendation concerning a systemic risk buffer."

[14] 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 risk 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.