ESRB
European Systemic Risk Board
European System of Financial Supervision

Assessment of the Norwegian notification in accordance with Article 133 of Directive (EU) 2013/36/EU concerning the application of a systemic risk buffer set between 3% and 5%

Introduction

On 5 November 2020, the Norwegian Ministry of Finance notified the European Systemic Risk Board (ESRB) of its intention to adopt a systemic risk buffer (SyRB) of 4.5% for exposures in Norway under Article 133(11) and (14) of Capital Requirements Directive IV (CRD IV)[1]. The Norwegian Ministry of Finance is the designated authority responsible for the application of Article 133 of CRD IV in Norway.[2] The measure provides for a change in the level and scope of an existing national buffer, with the application of a 4.5% SyRB to the domestic exposures of all credit institutions authorised in Norway, including the subsidiaries of institutions with parents established in other European Economic Area (EEA) countries. However, the existing national buffer has not yet been formally notified pursuant to Article 133 of CRD IV, as the framework was not made part of the European Economic Area (EEA) Agreement until 1 January 2020.

Pursuant to Article 133(14) of CRD IV read in conjunction with the EEA Agreement[3], where one subset of the financial sector is a subsidiary whose parent is established in another EEA country[4], the ESRB must issue a recommendation within one month of receiving the notification of the measures taken. The ESRB must assess the appropriateness of macroprudential policy measures before they are adopted by the EEA countries. The procedural framework for the provision of recommendations under Article 133 of CRD IV is clarified in Decision ESRB/2015/4[5].

The ESRB's recommendation focuses on assessing the systemic structural risks, the justification of the SyRB level, the effectiveness and proportionality of the measure, the likely impact on the domestic market and the EEA as a whole as well as on the justification against the use of alternative measures provided for in CRD IV or the Capital Requirements Regulation (CRR). After describing and providing background information

1 Directive 2013/36/EU of the European Parliament and of the Council of 26 June 2013 on access to the activity of credit institutions and the prudential supervision of credit institutions and investment firms, amending Directive 2002/87/EC and repealing Directive 2006/48/EC and 2006/49/EC (OJ L 176, 27.6.2013, p. 338).

2 In accordance with the Financial Undertakings Act, Sections 1-7 and Sections 14-3, the Norwegian Ministry of Finance is appointed as the designated authority.

3 As amended by Decision of the EEA Joint Committee No 79/2019 of 29 March 2019 amending Annex IX (Financial services) to the EEA Agreement [2019/2133]. OJ L 321, 12.12.2019, p. 170.

4 Upon incorporation of the CRD IV package into the EEA Agreement, the term "EEA country (ies) " refers to both the EU Member States and EEA EFTA countries.

5 Decision of the European Systemic Risk Board of 16 December 2015 on a coordination framework for the notification of national macroprudential policy measures by relevant authorities, the issuing of opinions and recommendations by the ESRB, and repealing Decision ESRB/2014/2.

on the measure **(Section 1)**, the ESRB has, in particular, assessed the rationale behind and merit of the measure against the following criteria, after which it concludes.

Section 2: Justification for using the SyRB

- Which long-term structural systemic risks have been identified as having the potential to pose a threat to financial stability at the national level? More specifically, the ESRB's assessment focuses on: (1) risks stemming from the propagation and amplification of shocks within the financial system; (2) risks stemming from structural characteristics of the banking sector; and (3) structural risks to the banking sector stemming from the real economy.

Section 3: Justification of the systemic risk buffer level

- Is the buffer level justified considering the identified systemic risk threatening the stability of the financial system at the national level?

Section 4: Effectiveness and proportionality

- Is the measure likely to achieve its intended objective and is the measure proportional?

Section 5: Assessment of cross-border effects and likely impact on the domestic market and EEA as a whole

- Is there an appropriate balance between the costs resulting from implementing the measure and the problem it aims to address, taking into account any potential cross-border spillover effects?
- What are the likely positive or negative effects of the SyRB on the domestic market and the EEA as a whole?

Section 6: Justification against the use of alternative measures in the CRD or the CRR

- Can alternative instruments provided for under CRD IV and the Capital Requirements Regulation (CRR)[6] (excluding Articles 458 and 459 of the CRR), alone or in combination, sufficiently address the identified systemic risk, taking into account their relative effectiveness?

The ESRB's assessment draws on the information provided by, and discussions with, the staff of the Norwegian Ministry of Finance, Norges Bank and Finanstilsynet.

[6] Regulation (EU) No 575/2013 of the European Parliament and of the Council of 26 June 2013 on prudential requirements for credit institutions and investment firms and amending Regulation (EU) No 648/2012 (OJ L 176, 27.6.2013, p. 1).

Section 1: Description and background of the measure

1.1 Description of the measure

The measure provides for a SyRB of 4.5% for domestic exposures for all credit institutions and financial holding companies authorised in Norway, including institutions that are subsidiaries of parent institutions established in other EEA countries. The buffer aims to target systemic risks in Norway, hence, the requirement will only apply to domestic exposures, in contrast to the current national buffer requirement which applies to all exposures and which is only in effect until 31 December 2020. Most Norwegian credit institutions[7] conduct all or most of their activities in Norway, and will therefore face an institution-specific SyRB of, or just below, 4.5%.

The SyRB is intended to promote domestic financial stability in Norway by safeguarding the resilience of the financial system and by ensuring that banks continue to be adequately capitalised given the high level of long-term systemic risk. The SyRB will be set by the Ministry of Finance pursuant to Article 133(11) and (14) of CRD IV. Although Norway already has a national buffer in place which aims to address these same risks, this is the first time that Norway has submitted a notification of this kind pursuant to CRD IV, given that this framework was only incorporated into the EEA Agreement as of 1 January 2020.

The measure is scheduled to enter into force by 31 December 2020; however, a transitional rule will apply to those banks that do not follow the advanced internal ratings-based (IRB) approach. For those institutions that do not use the advanced IRB approach, the buffer rate for all exposures will be 3% until 31 December 2022. This is to ensure that the changes to the SyRB for those institutions that are not significantly affected by the removal of the Basel I floor only enter into force after the reassessment of Pillar 2 requirements. These reassessments are conducted every two to three years. The transitional rule does not apply to systemically important institutions (SIIs), therefore, for these institutions, the SyRB requirement will apply from 31 December 2020. The SyRB will be introduced by way of an amendment to the Norwegian CRR/CRD IV Regulation of 22 August 2014 and published on the Ministry of Finance's website, in the Norwegian Official Legal Gazette and on the online legal information system "*Lovdata*". The measure, together with its justification, will also be published on the official website of the Ministry of Finance. The measure will be in place until further notice. The SyRB rate for domestic exposures will be evaluated every second year, as specified under the CRR/CRD IV.

The Norwegian Ministry of Finance intends to request reciprocation of the measure by all credit institutions in the EEA countries with exposures in Norway, subject to a materiality threshold. Some institutions established in other EEA countries have significant exposures and conduct core activities in the Norwegian lending market. The reciprocation of the Norwegian SyRB measure will primarily be relevant for a small number of large banking groups domiciled in other Nordic countries. The Nordic ministries responsible for matters relating to financial markets have thus signed a Memorandum of Understanding (MoU) on extended cooperation for cross-

[7] By Norwegian institutions, we mean credit institutions only.

border banking activities, which thereby facilitates mutual reciprocation of macroprudential measures. The ESRB will consider this reciprocation request once the request is submitted.

1.2 Background to the measure

The notification of the Norwegian Ministry of Finance concerns a new SyRB requirement in Norway. The change to the CRR/CRD IV framework in Norway would imply a decline in capital requirements for Norwegian banks, which is not intended by the Norwegian authorities, and hence raising the SyRB to 4.5% counteracts this unintended effect. Until the CRR/CRD IV framework was made part of the EEA Agreement on 1 January 2020, the presence of the Basel I floor and the absence of the small and medium-sized enterprises (SME) supporting factor (pursuant to CRD III of 2010) obliged all institutions authorised in Norway to hold more capital in order to reach a certain capital adequacy ratio. Although these national deviations from the CRR/CRD IV framework were not macroprudential in nature, they did affect the calibration of the existing national buffer. In other words, the Ministry of Finance took a somewhat pragmatic approach to the applicable national buffer calibration in order to avoid excessive requirements for domestic IRB banks. According to the Ministry of Finance, the current national buffer rate would probably have been set at a higher level, had the previous calibrations been made without deviations from the CRR/CRD IV framework.

The existing national buffer, which aims to address these same risks, has not yet been formally notified pursuant to Article 133 of the CRD, as the framework was not made part of the EEA Agreement until 1 January 2020. However, the Norwegian authorities did provide the ESRB with information on the implemented measure. The applicable (until 31 December 2020) national buffer rate currently stands at 5% for all exposures in SIIs[8] and at 3% for all exposures in all other institutions in Norway. The 3% buffer rate has been in effect since 1 July 2014 (at that time for all domestic institutions), while the 5% rate has been in effect since 1 July 2016. The Ministry of Finance opted for a higher national buffer rate for SIIs rather than for a separate buffer rate for other systemically important institutions (O-SII) in order to ensure the cumulative application of the institutions' buffer requirements. However, it should be noted that domestic SIIs were identified in accordance with Article 131 of CRD IV. In conjunction with these buffer rate changes, the Ministry of Finance intends to replace the higher national buffer rate (the add-on in the national buffer requirement for SIIs of 2%) with O-SII buffer rate requirements[9]. The Norwegian Ministry of Finance notified the activation of the latter to the ESRB on 5 November 2020. The Norwegian authorities first informed the ESRB of their intention to notify a new SyRB requirement at the end of 2019 but postponed final notification thereof until 5 November 2020 owing to the COVID-19 pandemic.

The SyRB will apply cumulatively alongside all other capital buffer requirements imposed by the Norwegian authorities. Currently, the capital-based macroprudential measures in place are the following:

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[8] SIIs are currently subject to an add-on in the national buffer requirement for all exposures of 2% (implying a total national buffer requirement of 5%). Once this new systemic risk buffer requirement is implemented on 31 December 2020, this add-on will be replaced by the relevant O-SII buffer requirements.

[9] The O-SII buffer requirement will apply at the highest level of consolidation to two identified O-SIIs as of 31 December 2020: a 2% buffer for DNB Bank ASA and a 1% buffer for Kommunalbanken AS.

- Risk weights: the risk weight applied to residential exposures for banks using the standardised approach in Norway is 35%, while for commercial real estate (CRE) exposures, risk weights are set between 100% and 150%, depending on the counterparty's rating and pursuant to Article 124 of the CRR. Pursuant to Article 164 of the CRR, for banks using the IRB approach, a floor of 20% for the exposure-weighted average loss given default (LGD) applies to retail exposures secured by residential property in Norway.
- A national buffer of 5% applies to all exposures in institutions identified as O-SIIs, (thus meaning that no O-SII buffer is applied) until 31 December 2020, which was not notified pursuant to CRD IV.
- A national buffer of 3% applies to all exposures in all other banks in Norway until 31 December 2020, which was not notified pursuant to CRD IV.
- The countercyclical buffer (CCyB) is currently set at 1%.[10]

In addition, the following measures were notified on 5 November 2020 and are to be implemented as of 31 December 2020 pursuant to CRD IV/CRR.

- A SyRB of 4.5% for domestic exposures, which applies to all Norwegian institutions, including subsidiaries of institutions with parents established in other EEA countries.
- An O-SII buffer requirement will apply at the highest level of consolidation to two identified O-SIIs as of 31 December 2020: a 2% buffer for DNB Bank ASA and a 1% buffer for Kommunalbanken AS.
- As of 31 December 2020, Norway also intends to implement a stricter national measure applicable to all Norwegian institutions that use the IRB approach for determining risk weights pursuant to Article 458 of the CRR. This will entail a floor for average risk weights of 20% for Norwegian residential real estate exposures and of 35% for Norwegian CRE exposures.

According to the Norwegian Ministry of Finance, the SyRB aims to address long-term structural risks (see the following section for further analysis) and it will also help to ensure that active macroprudential buffers remain effective.

Section 2: Analysis of the underlying long-term structural systemic risks

The SyRB aims to address the identified long-term structural systemic risks in the Norwegian financial system, which stem from the propagation and amplification of shocks within the financial system, the banking sector and the real economy.

In the following sections, further details regarding the assessment of structural risks to the banking sector stemming from the real economy (Section 2.1), risks stemming from the propagation and amplification of shocks within the financial system (Section 2.2), and risks stemming from structural characteristics of the banking sector (Section

[10] The CCyB was reduced from 2.5% in March 2020 with a view to addressing the potential impact of the COVID-19 pandemic and to alleviating the effects of the shock to the economy. See the ESRB's website at: **https://www.norges-bank.no/en/topics/financial-stability/macroprudential-supervision/Countercyclical-capital-buffer/measures-other-authorities/**

2.3) are provided. These pre-existing structural risks have been aggravated by the ongoing COVID-19 pandemic and its negative implications on the overall economy. However, the final implications are still highly uncertain.

2.1 Structural risks to the banking sector stemming from the real economy

The Norwegian authorities have long emphasised that high real estate prices and high household debt are two of the key vulnerabilities in the Norwegian financial system stemming from the real economy. Household indebtedness relative to disposable income is very high in Norway both historically and compared with other countries and, thus, constitutes a systemic risk for the Norwegian banking sector. Norwegian household debt as a percentage of disposable income is the second highest of all OECD countries, at 240%, according to the latest OECD data. Norwegian households use a large proportion of their income to service debt and are therefore vulnerable to a rise in interest rates or a fall in income. The COVID-19 pandemic has the potential to further negatively impact indebtedness, both of households and corporates, particularly once the moratoria and measures of a fiscal nature taken by the governments to protect the real economy from liquidity and solvency risks are ended. Moreover, Norwegian households have one of the highest shares of floating rate mortgage loans in Europe, which exacerbates this vulnerability. In high-debt households, even small disruptions can lead to impaired debt servicing capacity and tightened consumption, according to the Ministry of Finance, which in turn could lead to a fall in corporate earnings and weaken the debt servicing capacity of the corporate sector. If, as a result, banks suffer large losses on loans to the corporate market, banks may have problems maintaining their lending capacity, which can in turn intensify an economic downturn. In addition, the high level of debt in Norwegian households is related to the high prices for residential real estate (RRE). According to several national and international analyses, RRE prices are overvalued, both nation-wide and particularly in Oslo. RRE prices relative to disposable income in Oslo rank among the world's highest, constituting a source of vulnerability. The Norwegian authorities have also highlighted rising CRE prices in recent years, which have increased the vulnerability of the financial system further, as banks have significant exposures to CRE and related industries. A downward price correction could lead to significant losses for banks, as historically, CRE exposures have been the largest source of losses for banks and has contributed to solvency problems in the banking sector during previous crises. A price fall may also have ripple effects on other industries where banks have exposures, such as property development.

In June 2019, the ESRB also issued a warning to the Norwegian authorities,[11] as vulnerabilities in the Norwegian RRE sector were identified as being a source of systemic risk to financial stability. The ESRB has identified Norway as a country with certain medium-term vulnerabilities relating to RRE as sources of systemic risk to financial stability that were deemed not to have been sufficiently addressed.

In the context of the ESRB's warning to Norway, the ESRB's assessment of RRE vulnerabilities also stressed that, besides the very high and increasing household indebtedness compared with other

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[11] **See the ESRB's website at:**
https://www.esrb.europa.eu/pub/pdf/warnings/esrb.warning190923_no_warning~d3e4f2c135.en.pdf?4cf3e3031aa71bffaa0bd97a66b311ac

countries, there were signs of house price overvaluations in Norway following a long period of elevated and persistent growth in house prices. The ESRB's assessment emphasised that household indebtedness was very high as compared with other countries and with previous years, and that it had been increasing steadily over the past ten years. The ESRB also pointed out the high share of loans at variable interest rates, which also made households vulnerable to interest rate increases. Moreover, the ESRB underlined the signs of house price overvaluation, following a long period of elevated and persistent growth in house prices. Although in recent quarters house prices had moderated, transaction volumes had not decreased. The rate of home ownership through mortgages was high, which could potentially make households vulnerable to adverse economic and financial conditions or lead to adverse developments in the RRE market, which could have severe repercussions for the stability of the Norwegian financial system and thus lead to negative cross-border spillovers.

Against the background of the identified medium-term vulnerabilities in the RRE sector in Norway, the ESRB's assessment concluded that an economic or financial shock could lead to the materialisation of direct and indirect risks to financial stability. Potential direct risks to the banking system in Norway related to potential credit losses arising from new mortgage loans, since these loans were granted in an environment of possibly overvalued house prices. Moreover, households could experience a negative wealth effect or fall into negative equity if a decrease in house prices were significant. Furthermore, if, for example, unemployment increased and/or growth in household income decreased, some households could find it more difficult to service their debts. The associated negative household income and wealth effects could reinforce the initial shock if households were required to reduce consumption in order to service their housing loans. This could lead to second-round effects and an increase in risks to the credit institutions and the financial system as a whole.

The Norwegian economy is also characterised by a unilateral corporate sector, with a high dependence on the petroleum sector. The petroleum sector constitutes 17% of GDP, with petroleum accounting for more than 40% of total exports from Norway. Lower petroleum prices or reduced global demand could therefore have significant negative effects on the economy as a whole, particularly as Norway is a small, open economy and external shocks could propagate in the Norwegian banking sector. The vulnerability to a fall in oil and gas prices has lessened somewhat in recent years, as much of the petroleum wealth is placed in securities in international financial markets. However, the COVID-19 pandemic may put further pressure on the petroleum market owing to the decrease in global demand as a result of the lockdowns. However, disruptions in the petroleum sector could cause severe ripple effects to find their way to other sectors, leading to significant losses for credit institutions.

2.2 Risks stemming from the propagation and amplification of shocks within the financial system

According to the Norwegian Ministry of Finance, long-term structural systemic risks are high in Norway. Shocks could propagate and become amplified within the financial system. How quickly shocks amplify depends on structural features. If institutions are similar and interconnected, for instance through similar funding structure or exposures to the same markets, disruptions in the economy may affect several credit institutions at the same time and in the same way. This increases systemic risk.

The Ministry of Finance has highlighted the issue that the Norwegian institutions have similar funding structures and banks are closely interconnected through cross-holdings of covered bonds, which increases the risk of problems spreading quickly to other institutions. As at the end of 2019, the share of wholesale funding in Norwegian institutions increased substantially in the years leading up to the financial crisis, with all Norwegian banks, on average, relying on wholesale funding for 48% of their funding, making them vulnerable to market turbulence. The financial sector is also vulnerable to disruptions stemming from abroad, as a large share of wholesale funding is in foreign currency, albeit short-term foreign currency funding has reduced over recent years (adjusted for institutions' central bank deposits). Extensive use of covered bonds as a funding source has contributed to a lengthening of maturities on institutions' overall wholesale funding, which reduces refinancing risk. However, these covered bonds are largely held by other credit institutions for liquidity purposes, creating close interconnections within the banking system. This can cause other credit institutions to incur direct losses if an institution defaults on its obligations. Indirect losses can equally occur, if many institutions are forced to liquidate covered bond holdings at the same time.

Norwegian banks have similar and concentrated exposures to the real estate sector, where prices have also risen significantly over a long period, which has led to prices being at a high level. The ten largest banks in Norway, which account for more than 70% of total lending, have similar exposures with loans secured on real estate, constituting three-quarters or more of total lending to the Norwegian retail and corporate market (of which 61.2% constitutes RRE lending). Similarly, RRE lending relative to total lending of all Norwegian institutions constitutes about 46%, as at year-end 2019, while the ten largest Norwegian banks provide between 67.3% and 86.6% of their lending to the real estate sector. This excessive exposure concentration makes large parts of the financial sector vulnerable to common shocks in the RRE market. In addition, in comparison to other EEA countries, RRE loans as a percentage of GDP are among the highest.[12] Moreover, these market developments have contributed to a very high level of debt in Norwegian households by international comparison.[13] As of 2019, lending to CRE firms has also been elevated and accounts for the highest share of banks' share to the corporate sector (around 46%), which has, historically, inflicted the largest losses.

In the context of the ESRB's warning issued in 2019, the ESRB's assessment stressed that mortgage lending had been growing over the medium term, which constituted the main driver of growth in lending to households. Moreover, mortgage lending was systemically important for the banking sector, as it represented a high share of total loans granted by credit institutions. The banking sector could also be exposed to risks stemming from the international environment owing to the large share of foreign investors participating in the covered bond market and the interconnectedness of Norway's financial system with the other Nordic countries.

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[12] See the ESRB report entitled "Vulnerabilities in the residential real estate sectors of the EEA countries", ESRB, September 2019.

[13] Systemic risks arising from Norwegian household indebtedness is discussed in Section 2.1.

2.3 Risks stemming from structural characteristics of the banking sector

Risks stemming from structural characteristics of the banking sector are closely linked to those risks that arise from the propagation and amplification of shocks within the financial system (Section 2.2). Risks stemming from structural characteristics of the banking sector may not necessarily induce direct losses, but they may have the potential to become amplification channels in the event of a crisis.

The Norwegian Ministry of Finance highlighted that the main structural risk factors were: (1) the large Norwegian banking sector relative to GDP; (2) the importance of the banking sector for the financing of the Norwegian economy; and (3) the concentration of the domestic banking sector in a few large institutions. The total consolidated banking sector' assets amounted to around 225% of Norway's GDP as in 2019, which is above the average value of assets of EEA countries. With regard to the importance of the banking sector, banks and mortgage companies provided more than 80% of gross domestic lending to the non-financial sector in Norway as at June 2019, indicating the strong dependence of Norwegian borrowers on banks to finance their credit. The large concentration of the domestic banking sector in a few institutions (for example, the Herfindahl concentration index based on Norwegian banks' assets ranks among the highest among the EEA countries, while the five largest banks in Norway hold 56% of total domestic lending, while DNB alone accounts for around 30% of lending) could further amplify the risks in the banking sector. However, while the Norwegian banking sector is concentrated, the Norwegian authorities do not put much emphasis on this feature when assessing the SyRB.

Section 3: Justification of the systemic risk buffer level

Based on financial stability considerations it is necessary, according to the Norwegian Ministry of Finance, that credit institutions overall have the capacity to absorb losses that may occur as a result of severe shocks and disruptions in both the financial system and the real economy. Any impairment of institutions' solvency could contribute to further uncertainty and a lack of capacity to provide credit to creditworthy customers, thereby amplifying negative economic developments.

The Norwegian Ministry of Finance has concluded, based on the stress test results and experience from previous crises, that the current absolute capital and buffer requirements are proportional to the overall risks present in the financial system and furthermore that a SyRB of 4.5% for exposures in Norway is the most suitable measure for targeting substantial non-cyclical systemic risks present in Norway, with a view to maintaining current absolute capital and buffer requirements. A SyRB of 4.5% is considered sufficient to meet the risks in the financial system based on experience from previous crises and results from stress tests conducted by the Norwegian Financial Supervisory Authority (FSA) and Norges Bank. In particular, for larger institutions, a SyRB of 4.5% for domestic exposures is appropriate for maintaining the capital ratio at approximately the current level, which is also considered sufficient to address the risks in the financial system. The overall capital requirements implied by a SyRB of 4.5% is also within the range of estimates of socially optimal requirements, as indicated by the Norwegian authorities, and the potential for reciprocation may also contribute towards foreign credit institutions holding a capital level for exposures in Norway that therefore reflects the risks in the Norwegian financial

system. It should be noted, however, that the stress tests only cover Norwegian credit institutions and not foreign branches operating in Norway.

The stress tests conducted have, over several years, indicated that the largest banks, on average, under unlikely but not implausible scenarios, would have a CET1 capital shortfall relative to the combined buffer requirements and, hence, might cut back on lending with negative repercussions for the macroeconomy in such scenarios. Norwegian authorities therefore argue that the current real capital requirements should not be weakened. The stress tests also indicate that the second-round effect of a shock may be dampened if institutions can draw on buffers. The size of time-varying buffers may thus significantly affect institutions' behaviour.[14]

Norges Bank and the FSA's latest stress test conducted in November 2019 and June 2020, respectively, are based on a deep international recession with a strong increase in risk premia, and with serious consequences for the Norwegian economy. The results of the latest stress test by the FSA showed that 17 of the 20 largest banking groups experienced a drop in the CET1 capital ratio below the combined buffer requirements even if the CCyB is set to 0%. Several banking groups would have to use significant portions of other buffers in order to maintain the credit supply. In the rest of the banking sector, 48 out of 84 banks would hold capital below the combined buffer requirements, when the CCyB is assumed to remain at 1%. The impact on some banks is more pronounced than on others and banks with substantial losses could tighten lending (see Section 6.1 for further details on the capital effects of the SyRB). The Ministry of Finance stated that although activity in the Norwegian economy had picked up after the outbreak of the pandemic, uncertainty regarding future economic developments remained high, with significant losses to the banking sector still likely to occur. If the institutions were to reduce their absolute capital level, future stress tests could be expected to indicate greater reductions in capital adequacy, such that institutions would be compelled to draw on a larger share of their combined buffer in order to maintain the lending activity levels, as indicated by the Norwegian authorities.

According to the Ministry of Finance, not setting the SyRB to 4.5% (or higher) would be equivalent to lowering Norwegian banks' real capital requirements given the legislative change to the CRR/CRD IV framework, which could very well result in more alarming results from future stress tests, thereby weakening the banking system's resilience to the identified long-term systemic risks. The Ministry of Finance also notes that there are several aspects which are not captured by the stress test results, and which could contribute towards underestimating institutions' potential losses under realistic scenarios. In addition, the Ministry of Finance states that the accumulated losses in the stress tests are lower than institutions' actual losses during the Norwegian banking crisis between 1988 and 1992, in which the losses for the three largest banks resulted in a fall in the CET1 capital ratio by between 5 and 15 percentage points.

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[14] At the same time, possible stigma effects could arise in the event of unexpected losses forcing banks to breach their capital and buffer requirements.

Norwegian authorities have provided additional information showing that the overall capital requirement implied by a SyRB of 4.5% is also within the range of estimates of socially optimal requirements, based both on studies by Norwegian authorities and by the Basel Committee on Banking Supervision[15].

Taking the information and the results from the Norwegian authorities into account, the ESRB is of the view that a SyRB level of 4.5% for domestic exposures is appropriate considering the identified systemic risks threatening the stability of the Norwegian financial system. Both the results of the stress test performed as well as historical data on past severe crises in Norway point to a capital level that is achieved with a SyRB of 4.5% as being conducive to maintaining the banking system's resilience to the identified systemic risks.

Section 4: Effectiveness and proportionality of the measure

According to the Ministry of Finance, the SyRB requirement of 4.5% for exposures in Norway will effectively contribute towards maintaining Norwegian institutions' resilience and capacity to absorb losses at the level deemed necessary in the light of the intensity of systemic risks. The new legislation on Norwegian credit institutions' capital requirements was adopted in 2013, based on the CRR/CRD IV framework. It included a national buffer requirement of 3% for all exposures applicable to all Norwegian credit institutions, including the subsidiaries of parents established in other EEA countries, and in effect from 1 July 2014, as well as a 2% add-on for SIIs, in effect from 1 July 2016. Since the CRR/CRD IV framework was not made part of the EEA Agreement until January 2020, the Norwegian rulebook has, in the meantime, deviated from the framework in certain areas, as the obligations pursuant to the EEA Agreement were based on a previous iteration of the framework, namely CRD III of 2010. In particular, the SME supporting factor was not implemented and the Basel I floor has continued to function as a binding back-stop for banks using the IRB approach, according to the Ministry of Finance. These deviations have forced banks to hold more capital in order to reach a certain capital adequacy ratio, and have thus affected the design and calibration of the Pillar 1 requirements for Norwegian banks, including the current SyRB requirement. In preparation for the removal of the deviations, the Ministry of Finance has reassessed the scope and calibration of the SyRB requirement and concluded that the most effective way to mitigate the systemic risk (as outlined in Section 2) would 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 constitutes an alignment with the provisions of the CRR/CRD IV framework that facilitate reciprocation for domestic buffer rates.

A domestic buffer rate of 4.5 % is considered commensurate with the intensity of, and potential losses stemming from, structural risks in the Norwegian financial system, and with the risk tolerance implied by previous buffer decisions by Norwegian authorities. Norwegian authorities consider that, for the larger Norwegian banks, which constitute more than half of the domestic banking system, this buffer rate is economically

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[15] See the Basel Committee on Banking Supervision (BCBS) , "The costs and benefits of bank capital – a review of the literature", *Working Paper*, No 37, BCBS, June 2019 and Kragh-Sørensen, Kasper, "Optimal capital adequacy ratios for Norwegian banks", *Staff Memo*, No 29, Norges Bank, December 2012.

approximately equivalent to the 3% buffer rate applicable to all exposures before the introduction of the CRR/CRD IV framework. The current buffer rate was set on the basis of significantly more conservative risk weights, owing to the presence of the Basel I floor and the absence of the SME supporting factor. Without these deviations from the CRR/CRD IV framework being in place, the first buffer decision in 2013 would have implied a higher buffer rate than 3% to address the risks present at the time, according to the Norwegian authorities. In other words, the Ministry of Finance took a somewhat pragmatic and simple approach to the buffer calibration in order to avoid excessive requirements for domestic IRB institutions. According to the Ministry of Finance, the buffer rate would probably have been set at a higher level, had the previous calibrations been made without the deviations from the CRR/CRD IV framework and the related absence of the Basel I floor. Thus, based on experience from previous crises and the results from the stress tests conducted by the FSA and Norges Bank, the Ministry of Finance has concluded that the overall capital and buffer requirement, which until now has been imposed on the larger Norwegian institutions, was proportional to the overall risks present in the financial system. That is to say, the overall requirement should be maintained at approximately the pre-2020 level in real terms, as the intensity of the systemic risks is similar to that of 2013, which justifies a SyRB rate of 4.5%.

The stress test results discussed in the notification provide evidence in favour of the appropriateness and effectiveness of the 4.5% level. One of the stress tests is based on Norwegian pre-2020 risk-weighting rules, which required a similar real CET1 capital level as the SyRB at 4.5% for domestic exposures using the current risk-weighting rules under the CRR/CRD IV framework. This means that even with a SyRB of 4.5%, Norwegian banks would have to use significant portions of their buffers in order to maintain credit supply under low-probability, but not implausible, scenarios. Some banks may, nevertheless, tighten lending considerably, as shown by the stress test of the Norwegian Ministry of Finance. Moreover, the Ministry also highlighted that there are several aspects that are not being captured by the stress tests, which may contribute towards underestimating banks' potential losses under realistic scenarios. Therefore, according to the Ministry of Finance, not setting the SyRB at 4.5% (or higher) would be equivalent to lowering Norwegian banks' real capital requirements, which could very well result in more alarming results from future stress tests, and thus weaken the banking system's resilience. It should be noted, however, that the stress tests conducted only cover Norwegian credit institutions. Therefore, the stress test results might give an imperfect assessment of the appropriate level of the SyRB for the whole banking system operating in Norway.

For non-SIIs, there will be an increase in the buffer requirement, from 3% of all exposures to 4.5% of domestic exposures only. The Ministry of Finance intends to adopt a transitional rule to promote consistency between Pillar 1 and Pillar 2 requirements. Thus, for institutions that are not significantly affected by the removal of the Basel I floor, the new SyRB requirement will enter into effect after Pillar 2 requirements have possibly been reassessed, these being conducted every second or third year for such institutions based on the information from the Ministry of Finance. According to the Norwegian authorities, the proposed buffer rate is also economically approximately equivalent to the current 3% buffer rate for the larger Norwegian institutions, which constitute more than half of the domestic banking system.

The ESRB is of the view that the measure is effective and proportionate, as it contributes to mitigating the identified long-term structural risks in the Norwegian banking sector. Based on the stress test results by the

Norwegian authorities, the measure will effectively promote financial stability in Norway by maintaining Norwegian credit institutions' capital at levels sufficient to conserve their current loss-absorption capacity. Lowering Norwegian banks' real capital requirements would be less effective in safeguarding financial stability in the event of a severe stress scenario.

Section 5: Analysis of domestic and cross-border effects

5.1 Effects on domestic institutions and the Norwegian market

The SyRB is expected to promote domestic financial stability by contributing to increasing the resilience and the loss-absorption capacity of the Norwegian banking system. A SyRB of 4.5% will contribute to maintaining the magnitude of disruptions in the provision of credit and other financial services at approximately the pre-2020 level. As the measure implies a continuation of approximately the pre-2020 capital levels, the new buffer requirement is not expected to cause capital constraints or higher funding costs for institutions, nor any change in the credit conditions for households and non-financial corporations, according to the Norwegian Ministry of Finance. This applies, in particular, to domestic institutions in the Norwegian market, as some foreign institutions active in Norway may face an increase in their consolidated capital requirements in the case of reciprocation. However, given the current exceptional uncertainty surrounding the outlook for the financial system and the real economy both in Norway and in EEA countries due to the COVID-19 pandemic, capital constraints for Norwegian institutions cannot be fully excluded at this point.

All Norwegian institutions had a CET1 capital adequacy ratio of above 12.5% as at 30 June 2020, according to the Ministry of Finance. Most Norwegian institutions conduct all or most of their activities in Norway and will therefore face an institution-specific SyRB requirement of, or just below, 4.5%, implying an overall CET1 capital requirement of 12.5% for non-systemically important institutions (non-SIIs). As at 30 June 2020, the two previously mentioned SIIs had CET1 capital ratios which exceeded their overall Pillar 1 and 2 requirements applicable from 31 December 2020. As regards the five subsidiaries of parents established in other EEA countries, currently, three subsidiaries mainly have exposures in Norway and will thus be subject to an increase in capital requirements by close to 1.5 percentage points. However, these institutions have CET1 capital which exceeds the new requirement, as indicated by the Norwegian authorities. The fourth subsidiary holds the lion's share of its exposures in other Nordic countries, so for this institution the SyRB requirement, in nominal terms, will therefore be reduced.

Since the capital needed for Norwegian institutions to meet the SyRB requirement is limited, the impact on institutions' capitalisation is expected to be near neutral, as stated by the Ministry of Finance. While all Norwegian institutions had a CET1 capital ratio above the overall CET1 capital requirement as at 30 June 2020, some institutions may need to increase their capital levels somewhat to maintain a certain margin above the minimum capital and buffer requirements. The transitional rule should ensure that for those banks that do not use the advanced IRB approach, the changes in the SyRB level will not enter into effect until 31 December 2022, after the reassessment of their Pillar 2 requirements. The Ministry of Finance also stated that for Norwegian institutions overall, neither funding costs nor lending growth is expected to be affected significantly. If the SyRB is reciprocated

by other EEA countries (see Section 5.2), foreign institutions operating in Norway may be subject to increases in their capital requirements. The ESRB shall consider this reciprocation request at a future date.

The measure is not expected to contribute to leakages or regulatory arbitrage within the Norwegian financial system. Experiences with current capital levels in Norwegian institutions do not suggest that there is significant potential for migration to “shadow banking” or other sectors of the financial system. The scope for regulatory arbitrage is generally very limited within the Norwegian financial system, owing to the consistent adherence to the principle of “same risk, same regulation”. According to the Ministry of Finance, the profitability of the Norwegian banking sector is also high compared with other European banking sectors, making a rebalance towards foreign exposures less likely. Norwegian banks have posted a return on equity (RoE) of around 12% over the past years, before it dropped to below 10% in the first half of 2020. In addition, the Norwegian authorities argue that provided that the SyRB requirement is reciprocated by other EEA countries, the measure is expected to reduce the potential for leakages to foreign financial systems as well.

The Ministry of Finance presumes that capital requirements in other EEA countries are in line with the risk level in these countries, thereby providing a level playing field and making it less attractive to shift exposures between countries. The Ministry of Finance has furthermore not experienced notable rebalances of Norwegian banks’ balance sheets owing to capital requirements, and therefore this is currently not a major concern.

The Norwegian Ministry of Finance did not provide information on the possible impact of the measure on domestic economic growth. Nonetheless, given that most domestic banks have the capital needed to meet the SyRB requirement, the impact is expected to be minor, as institutions’ funding costs and lending rates are not expected to be severely impacted. However, given the exceptionally uncertain outlook for the economy and the financial system caused by the COVID-19 pandemic, a SyRB of 4.5% might potentially have short-term cyclical effects on the functioning of the financial system in Norway. Potential unintended consequences should therefore be mentioned as they might emerge even in spite of the strong capitalisation of the Norwegian banking system prior to the pandemic. While the Norwegian Ministry of Finance highlights, in this context, that structural systemic risks are likely to remain after the pandemic, unintended consequences could arise.

5.2 Cross-border effects and likely impact on the EEA as a whole

The Norwegian Ministry of Finance emphasised that the SyRB requirement would not apply directly to foreign institutions operating in Norway through their branches. However, at a later point, the Ministry of Finance intends to request that the ESRB issue a recommendation to other EEA countries to reciprocate the requirement, subject to an adequate materiality threshold. According to the Ministry of Finance, institutions established in other EEA countries have significant exposures and conduct activities in the Norwegian lending market and should thus be subject to the same requirements as Norwegian institutions. The Nordic ministries responsible for financial markets’ matters have also signed a MoU on extended cooperation regarding cross-border banking activities in the Nordic countries, i.e. to facilitate mutual reciprocation for macroprudential measures, even when this is not required by EU/EEA legislation. In the MoU, the ministries acknowledge the ESRB

recommendations as constituting a minimum standard for reciprocation of other countries' macroprudential measures.

According to the information provided by the Norwegian Ministry of Finance, reciprocation of the Norwegian SyRB requirement will primarily be relevant for five large banking groups domiciled in other Nordic countries. These five banking groups (Nordea, Danske Bank, Handelsbanken, SEB and Swedbank) have branches in Norway, with estimated market shares in the Norwegian lending market of between 1.6% and 12.6% (as of year-end 2017),[16] as estimated by the Norwegian authorities. The Norwegian-based activities are significant for several of the institutions and lending in Norway accounts for between 4% and 15% of these institutions' total lending at year-end 2018. Thus, the Ministry of Finance considers that the measure may have a significant positive impact on the Nordic institutions and the other EEA markets where they conduct activities, since it could mitigate the effect of potential losses on Norwegian credit exposures. Reciprocation of the SyRB requirement may result in an increase in the institutions' funding costs or effects on bank lending. However, their improved resilience is expected to have a positive impact on other EEA credit markets in the longer run, given that the Nordic EEA countries are highly integrated.

The Ministry of Finance emphasises in the notification that – under certain conditions – the increase of the SyRB is not expected to be large for the five Nordic banking groups if the SyRB is reciprocated. However, while all banking groups were subject to a buffer requirement of 3% for all exposures as at year-end 2019, the Finnish authorities have decided to deactivate the SyRB requirement in response to the COVID-19 pandemic in March 2020. Therefore, the reciprocation of the Norwegian SyRB requirement might increase capital requirements for banking groups headquartered in Finland.[17] If the Nordic banking groups are to meet O-SII buffers in addition to the Norwegian SyRB, the increase in the capital requirement could be greater, up to 0.7 percentage point, as estimated by the Ministry of Finance. This estimation is however subject to several uncertainties related to the reciprocation request and implementation of the reciprocation by EEA countries. Thus, the SyRB requirement of 4.5% may have non-negligible effects on some institutions, not just due to the high uncertainties and potential impact of the COVID-19 pandemic on their resilience but also given the different legal requirements in Norway compared to the other Nordic countries (CRR/CRD IV versus CRR II/CRD V). Once the ESRB receives the reciprocation request from the Norwegian authorities, the ESRB will provide an assessment of the appropriateness of the reciprocation of the SyRB in a separate recommendation. The assessment will also need to consider potential level playing field effects as well as the additional level of complexity owing to the different regulatory and supervisory frameworks and the resulting potential overlaps in buffer requirements between Norway and the other Nordic countries. In this assessment, potential cyclical effects owing to increases in the capital requirements for some banking groups in Nordic countries may also need to be reflected in light of the uncertainties of the economic

[16] Even though the data is not very recent, the Norwegian Ministry of Finance emphasised that the data is still descriptive of the current situation.

[17] The Ministry's assessment concluded that a SyRB of 4.5% for exposures in Norway may imply an increase in the consolidated capital requirements of the five banking groups by between 0.22 and 0.06 percentage point based on data as at end-2018, provided that the institutions are not subject to SyRB requirements for exposures in Norway other than the Norwegian SyRB. However, given the uncertainties around the COVID-19 pandemic and the macroprudential policies taken by EEA countries, the increases may turn out to be higher than as of end-2019.

outlook in the short to medium term owing to the COVID-19 pandemic. Therefore, phase-in periods or other transitional rules for reciprocation may need to be discussed in the recommendation, too.

The Ministry of Finance also argues that provided that the SyRB requirement is reciprocated by other EEA countries, the measure is expected to reduce the potential for leakages to foreign financial systems, in addition to ensuring that foreign banks' loss-absorbing capacity is aligned with their risk exposures in the Norwegian market. Even though foreign institutions' market shares in the Norwegian credit market have been fairly stable over the last decade, they have benefitted from somewhat less stringent requirements according to the Norwegian authorities, given the earlier introduction of the CRD IV/CRR framework in the other Nordic countries at year end-2013 and the related absence of the Basel I floor and the presence of the SME supporting factor since then. If the SyRB requirement is not reciprocated, particularly by Nordic EEA countries, the potential for leakages to foreign institutions is considered significant by the Norwegian authorities. As the systemic risks associated with exposures in Norway would not be sufficiently reflected in these institutions' capital requirements, the risk of disruption to foreign financial systems could increase. This would, in turn, be expected to have negative spillover effects also on the Norwegian economy. Thus, removing the Basel I floor and applying the SME supporting factor to Norwegian banks may level the playing field in this context, considering that other measures and requirements for internal models (e.g. the comprehensive package of regulatory standards and guidelines on internal models by the European Banking Authority, the European Central Bank's targeted review of internal models (TRIM) exercise, Pillar 2 requirements etc.) have been introduced in EU countries since the removal of the Basel I floor. Despite these measures, reciprocation of the measure may level the playing field between Norwegian and foreign banks operating in Norway. Its challenges and advantages will need to be assessed in more detail in a separate recommendation.

Although the reciprocation of the requirement may entail a slight short-term increase in the institutions' funding costs, their improved resilience is also expected to have a positive impact on other EEA credit markets. The Ministry of Finance also highlights that the expected positive impact on the EEA as a whole is owed to the general integration of national markets, particularly among the Nordic EEA countries. A setback in the Norwegian economy, which becomes less likely with a SyRB requirement at 4.5%, could have serious negative effects on neighbouring economies.

Section 6: Justification against the use of alternative measures in the CRD or CRR

The Norwegian Ministry of Finance considers the available measures in the CRD or in the CRR (excluding Articles 458 and 459 of the CRR) to be insufficient to address the identified long-term structural risks in Norway.

a) Increasing the risk weights for banks that use the standardised approach to credit risk (Article 124 of the CRR)

Competent authorities may impose higher risk weights for exposures secured by mortgages on credit institutions that apply the standardised approach, on the basis of financial stability considerations. Pursuant to Article 124 of the CRR, the risk weights under the standardised approach may be set between 35%

and 150% for exposures secured by mortgages on residential property, and between 50% and 150% for exposures secured on commercial immovable property.

Article 124 of the CRR would not be effective in meeting the measure's objectives, given that banks using the IRB approach had a combined market share of 76% in the RRE market and 55% of all loans secured by CRE at year-end 2019. The risk weight for residential exposures in Norway remains at 35%, as this level is considered to be sufficient for institutions using the standardised approach. For commercial exposure, risk weights are set between 100% and 150%, depending on the counterparty's rating, as risk weights for such exposures as low as 50% would not be considered adequate. Increasing RRE risk weights under Article 124 would only further increase the difference between banks using the standardised approach and the IRB approach.

b) Increasing the loss given default (LGD) floor for banks that apply the IRB approach for credit risk (Article 164 of the CRR)

Competent authorities may set higher minimum values of exposure-weighted average LGD for retail exposures secured by immovable property, on the basis of financial stability considerations. The exposure-weighted average LGD for all retail exposures secured by residential and commercial immovable property and which does not benefit from guarantees from central governments must not be lower than 10% and 15%, respectively. The LGD is only one of the parameters used in the risk-weight function. Increasing the LGD directly increases the risk weights.

According to the Norwegian Ministry of Finance, a 20% floor on retail exposures secured by residential property in Norway addresses uncertainty associated with internal modelling. The measure was introduced in 2014, together with tightened requirements for institutions' residential mortgage models, and since then the Norwegian FSA has observed a fall in risk weights. However, it has been noted that higher house prices and higher household indebtedness has increased the risk present in the mortgage market.

Given the narrower focus of Article 164, which only targets the LGD and not the probability of default (PD), such a measure would not sufficiently address the identified long-term structural risks in Norway. In particular, it could even lead to unintended results by affecting banks' risk weights in a disproportionate manner given that the IRB risk- weight formula is a linear function of the LGD parameter.

c) Using Pillar 2 (Articles 101, 103, 104 and 105 of CRD IV)

Competent authorities may apply supervisory measures to address risks that are not sufficiently covered by Pillar 1, including risks that an institution poses to the financial system. These powers can be applied under the supervisory review and evaluation process (SREP), one of the components of Pillar 2.[18]

[18] It should be noted that the European legislator, under CRD V, decided to discontinue the macroprudential use of Pillar 2, with this decision taking effect on 29 December 2020 in the European Union.

However, the institution-specific Pillar 2 requirements pursuant to Article 104 of the CRD must be tailored to each institution's specific situation. The SREP has a microprudential focus and therefore may not be effective in capturing macroprudential concerns. On a bank-by-bank basis, the Norwegian authorities did not identify any risks that the banks would pose to the financial system. However, the Norwegian authorities identified long-term structural risks in Norway as a macroprudential or systemic risk that poses a threat to financial stability at the national level.

At this stage, there are no grounds for activating Pillar 2 as a macroprudential tool to address the identified long-term structural risks in Norway. Given that the SREP process is mainly a microprudential assessment, and since the proposed measure is motived by macroprudential concerns arising from related systemic risks that cannot be sufficiently captured under Pillar 1, the application of the measure established under Article 133 CRR remains warranted.

d) Using the countercyclical capital buffer (Article 136 of CRD IV)

The countercyclical capital buffer (CCyB) can be used to counter some of the procyclicality in the financial system. The CCyB is aimed at increasing the resilience of the banking system during periods of excessive credit growth. Thus, the CCyB addresses cyclical risks and is based on the relationship between growth in total credit and GDP growth. The CCyB rate is set on a quarterly basis by the designated authority that follows a specific methodology based on an ESRB recommendation.[19] The Norwegian Ministry of Finance has gradually increased the CCyB rate for credit risk exposures located in Norway to 2.5% (effective from year-end 2019) over the last few years, in response to a build-up of financial imbalances. The CCyB rate is applied as a percentage of the total amount of risk exposures calculated in accordance with Article 92(3) of Regulation (EU) No 575/2013. In March 2020, the Norwegian Ministry of Finance decreased the CCyB to 1% to address the potential negative impact of the COVID-19 pandemic, particularly to prevent tighter lending standards from amplifying a downturn. The Norwegian Ministry of Finance also highlighted that the CCyB is the primary tool to be used to alleviate the effects of a shock to the economy. Thus, if necessary, the authorities signalled their willingness to release the remaining CCyB to avoid tighter lending conditions in the coming months.

The CCyB is not an appropriate tool for addressing the identified long-term structural systemic risks in Norway. Even though the structural and cyclical dimensions of systemic risk may not always be easily distinguishable, the CCyB requirement should not be calibrated to mitigate long-term structural systemic risks. The framework for assessing the level of the CCyB in Norway is based on a broad set of indicators, which also consider financial imbalances, such as the pricing of risk and lending conditions, real estate market vulnerabilities and vulnerabilities in the household and corporate sector, as indicated by the Norges Bank.[20] While the indicators considered for the CCyB are cyclical systemic risk indicators, Norwegian authorities consider structural risk

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[19] Recommendation of the European Systemic Risk Board of 18 June 2014 on guidance for setting countercyclical buffer rates (ESRB/2014/1).

[20] See Norges Bank (2019), A framework for advice on the countercyclical capital buffer. Norges Bank Papers no. 4.

indicators for the SyRB requirement, which entail more persistent financial system vulnerabilities. The application of the CCyB would not reduce the identified structural systemic risks that are assigned to the risk categories as described above.

e) Using the global or other systemically important institution buffer (Article 131 of CRD IV)

The buffer requirement for SIIs is applied to financial institutions that pose substantial systemic risks to the banking system. The buffer for SIIs aims to reduce SIIs' PD, which may have serious consequences for the financial system and the real economy, while strengthening their market confidence by increasing their loss-absorption capacity. The buffer reduces the cost for the general public in the event of a bank's insolvency and thus acts as an additional cushion for the stability of individual SIIs.

The Norwegian Ministry of Finance notified the activation of the O-SII buffer requirement on 5 November 2020. The EBA issued a guideline (EBA/GL/2014/10) to identify O-SIIs by assessing their systemic risks in the EEA countries' banking sector. The guideline is based on a minimum mandatory framework of criteria and indicators. Currently, two Norwegian institutions are identified as SIIs, based on the two-step procedure outlined in the guideline. Even though a number of Norwegian banks contribute, to some degree, to the concentration risk in Norway, the O-SII buffer should not be extended for individual institutions, as the risks identified impact all Norwegian institutions and not just the large institutions, which need to be identified in accordance with the aforementioned EBA guideline. At the same time, Norway has no global SIIs.

The O-SII buffer is not the appropriate tool to address the identified structural systemic risks, as the identified risks affect all Norwegian banks and not just SIIs. The measure intends to set a SyRB for all Norwegian banks, not just the identified SIIs. In addition, the O-SII buffer applies to all exposures, not just domestic exposures, where systemic risks have been identified in Norway.

Conclusions

According to the Norwegian Ministry of Finance, the main purpose of the SyRB requirement of 4.5% for domestic exposures is to maintain Norwegian credit institutions' resilience to loan losses and other disruptions that may arise as a result of structural vulnerabilities and other long-term systemic risks in the Norwegian economy. The key vulnerabilities in the Norwegian economy result from a combination of risks stemming from: (1) the propagation and amplification of shocks within the financial system; (2) from structural characteristics of the banking sector; and (3) from structural risks to the banking sector stemming from the real economy. The Ministry of Finance has highlighted that the key vulnerabilities are high real estate prices and high household indebtedness in Norway, which can reinforce each other, also due to the pronounced interconnectedness, the large size and the high concentration of the banking sector.

The ESRB is of the view that the level of the measure is appropriate given the identified systemic risks threatening the stability of the Norwegian financial system. The calibration of the level of the measure is obtained both from Norwegian stress test results and losses in connection with historical crisis events, which is also

within the range of socially optimal capital requirements based on studies by Norway as well as the Basel Committee on Banking Supervision. A SyRB set at 4.5% for domestic exposures is the appropriate level considered commensurate with the intensity of structural risks in the Norwegian financial system, as a level of capital below that would weaken the banking system's resilience to the identified systemic risks and could adversely contribute towards impacting financial stability in Norway.

The ESRB considers the measure to be effective and proportionate. The measure intends to maintain the loss-absorption capacity and the resilience of Norwegian institutions to long-term non-cyclical risks and, therefore, contributes to safeguarding financial stability both in Norway and in the EEA as a whole. Based on the losses in previous crises and the results from the stress tests, the Ministry of Finance has concluded that the overall SyRB requirements are proportional to the overall risks present in the Norwegian financial system. Thus, to guarantee the effectiveness of the SyRB, the overall capital requirements should be maintained at approximately the pre-2020 level in real terms, which requires a SyRB of 4.5%.

The ESRB considers the effects of the planned measure on the Norwegian domestic market and its credit institutions to be limited. Applying the measure also to subsidiaries of institutions established in other EEA countries is necessary to provide a level playing field in the domestic market and to avoid leakages and regulatory arbitrage. The information provided by the Norwegian Ministry of Finance highlights that the capital needed for Norwegian credit institutions, including subsidiaries of parents headquartered in other EEA countries, to meet the SyRB requirement of 4.5% is limited, which is why the impact on domestic institutions' capitalisation is expected to be near neutral. For banks that do not using the advanced IRB approach, the measure will apply from 31 December 2022 only. This transitional period, applicable to banks that are not significantly affected by the removal of the Basel I floor, should ensure that the changes in the SyRB requirement enter into effect after a reassessment of the Pillar 2 requirements, so that the impact on domestic banks and their lending capacity remains limited.Given the exceptionally uncertain outlook of the economy and the financial system caused by the COVID-19 pandemic, a SyRB of 4.5% may potentially have short-term cyclical effects on the functioning of the financial system in Norway. These unintended consequences might emerge in spite of the strong capitalisation of the Norwegian banking system prior to the pandemic.

Based on the information provided, the ESRB concludes that the measure would not entail disproportionate adverse effects on the EEA as a whole or other financial systems. The planned reciprocation of the SyRB intends to reduce the potential for leakages to foreign institutions. The Ministry of Finance furthermore intends to request the reciprocation of the SyRB for all EEA institutions with exposures to Norway in order to reduce the potential for leakages to foreign institutions, which would otherwise be considered to be significant. The ESRB shall be dealing separately with the implications of the reciprocation request in a recommendation. The high uncertainties surrounding the COVID-19 pandemic as well as the additional level of complexity owing to the different regulatory and supervisory frameworks and the resulting potential overlaps in buffer requirements between Norway and the other Nordic countries (CRR/CRD IV versus CRR II/CRD V) will also need to be considered when assessing the potential impact of the measure on foreign banks. Even though the reciprocation of the SyRB may result in a small short-term increase in foreign institutions' funding costs, their increased resilience is expected to have a positive impact on other EEA countries' credit markets. According to the Norwegian Ministry of Finance, the increase of the

SyRB is – under certain conditions – not expected to be large for some Nordic banking groups if the SyRB is reciprocated, as most of those institutions were already subject to a buffer requirement of 3% for all exposures as at year-end 2019. However, as Nordic countries have taken macroprudential measures to address the impact of the COVID-19 pandemic, the increase in the capital requirement may be higher in case of reciprocation. Nonetheless, the measure should not have a disproportionate negative effect on the EEA as a whole and the reciprocation could be seen as levelling the playing field.

The ESRB is of the view that none of the existing measures in the CRR and CRD IV, excluding Articles 458 and 459 CRR, alone or in combination, are sufficient to address the identified macroprudential or systemic risk in Norway, taking into account the relative effectiveness of those measures. Measures such as those listed under Articles 124 and 164 of the CRR, as well as the Pillar 2 requirements (Articles 101, 103, 104 and 105 of CRD IV), the countercyclical capital buffer (Article 136 of the CRR) or the O-SII and G-SII buffer (Article 131 of CRD IV), are considered inappropriate, as they do not provide the intended incentives, are too broad-based, or do not address the relevant type of risk, exposure or credit institution.