FINANSTILSYNET
THE FINANCIAL SUPERVISORY
AUTHORITY OF NORWAY

Regulation of capital and liquidity
Overview of themes from the current debate

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The economics of banking
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Finanstilsynet
(Financial Supervisory Authority)

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- A government agency reporting to the Ministry of Finance, with a Board, and financed by the industry
- Integrated financial supervisor since 1986 (first in Europe), covering banking, insurance and securities
- Main goal: To promote financial stability and well functioning markets through supervision of institutions and markets
- Instruments: Supervision and monitoring, licensing, regulation, information/communication
- Staff of appr. 250 in 4 departments: Administration, Finance and Insurance Supervision, Accounting and Auditing Supervision, and Capital Market Supervision.

Financial stability – who is responsible?

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- The Ministry of Finance has the overall responsibility for financial stability and the regulatory framework.
- Norges Bank has the operating responsibility for monetary policy
- Finanstilsynet is responsible for supervision of institutions and market places, and prepares a significant part of regulatory changes.
- Norges Bank and Finanstilsynet monitor institutions, markets and payment systems to identify threats to financial stability.
- Both Norges Bank (semi-annually), Finanstilsynet (annually) and the Ministry of Finance (annually) regularly publish assessments of financial stability.
- Tri-partite meetings between the authorities are being arranged (since 2006) in order to secure a common understanding of the situation and coordinate possible measures.

The financial crisis – some main ingredients

- Macroeconomic imbalances in the international economy, huge increase in global liquidity, low yields on risk-free investments
- ”search for yield”, financial innovation, and very low risk premiums across instruments and regions
- Rapid growth of securitised credit and increasing complexity of financial instruments used in the securitisation process
- Reduced credit standards and increased leverage in the non-financial sector
- Soaring housing prices and other asset prices
- Increased leverage within the banking sector and in the ”shadow banking system”

Stages of the crisis

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- Losses on subprime housing loans and structured credit products in 2006/2007
- Hedgefund and interbank problems from mid 2007
- Increasing subprime related losses, falling house prices, increasing liquidity and solvency problems up to the fall of 2008
- Lehman collaps in September – from turmoil to crisis
- Government liquidity support measures from October 2008
- First signs of stabilisation spring 2009
- 2010: Slow recovery of the economy, but increasing downside risk

Why did it happen?

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- Weaknesses in financial institutions risk management and governance
  - Remuneration and incentive schemes stimulated short-term returns and overlooked risk
  - Poor oversight of risks on off-balance activities and securitisation
  - Underestimation of risk, in particular liquidity risk, and capital needs

- Regulatory and supervisory weaknesses
  - Important parts of the financial system not adequately regulated
  - Capital requirement coverage not broad enough
  - Underestimation of market liquidity and funding risk
  - Poor oversight of risk distributions, risk correlations and interconnectedness
  - Too much reliance on rating and models
  - Systemic risk not sufficiently integrated in “micro”-supervision

Why did it happen?

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- Weaknesses in accounting rules
  - Valuation of complex instruments and instruments traded in illiquid markets, are very difficult
  - Loan loss provisions are not sufficiently forward-looking and do not cover expected losses

- Weaknesses in macroeconomic policy

- Weaknesses in the international architecture for monitoring, coordinating and addressing identified risks and imbalances. Some of the risks and weaknesses came as a surprise to policy makers.

Regulatory reform

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- Weaknesses in regulation and supervision an important explanation of the most severe financial crisis since the 1930s.
- Banks were in the epicenter of the storm. Insurance and pensions indirectly affected.
- Large-scale international work on improving regulation and supervision of the financial industry in general, and banks in particular.
- Reform work on parallell tracks in several international institutions, such as G20, Basel Committee, EU, European supervisory committees.
- The important changes in Norwegian regulation take place via changes in the EU directives
- The need for regulatory reform differs across countries. The impact of the reform will affect all countries.

G20: Strenghtening international financial regulation

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- State leaders from the G20 countries discussed supervision and regulation of financial markets in Washington 20 November 2008, in London 2 April and in Pittsburgh 24 -25 September 2009.
- Upcoming meetings in Washington (April), Canada (June) and Seoul (November).
- The institutional framework for monitoring and addressing international financial stability issues did not prevent the crisis.
- The Basel Committee (banking), International Association of Insurance Supervisors (IAIS), and the International Organisation of Securities Commission (IOSCO) can not make legally binding decisions on international regulation.
- Neither the UN nor the IMF has the necessary political power
- It is still uncertain if the G20 will represent a permanent political anchor for international regulation.

G20

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- The London-declaration pointed to the importance of making the whole financial system subject to regulation and supervision:
  - *” We have agreed that all systemically important financial institutions, markets and instruments should be subject to an appropriate degree of regulation and oversight.”*

- In the declaration from the Pittsburg meeting: “…agreement on an international framework of reform in the following critical areas”:
  - Building high quality capital and mitigating pro-cyclicality
  - Reforming compensation practices to support financial stability
  - Improving over-the-counter derivatives markets
  - Addressing cross-border resolutions and systemically important financial institution

G20

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- In its report to the G20-meeting in Pittsburgh, the Financial Stability Board reported on achievements to date, and the work underway.

- FSB identifies the following important areas:
  - Strengthening the global capital framework
  - Making global liquidity more robust
  - Reducing the moral hazard by systemically important institutions
  - Strengthening the accounting standards
  - Improving compensation practices
  - Expanding oversight of the financial system (e.g. hedge fonds, rating agencies)
  - Strengthening the robustness of the OTC derivatives markets
  - Relaunching securitisation on a sound basis
  - Adherence to international standards

EU

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- Most measures for crisis resolutions in 2008 were taken nationally. The co-ordination on the European level was not very impressive.

- To improve coordination and to strenghten the regulatory and supervisory framwork, it is proposed to establish

- European Systemic Risk Board **(ESRB):**
  - Monitor and assess potential threats to financial stability (a European macro-prudential perspective)
  - Allow for risk-assessments to be translated into action by the relevant authorities

- European System of Financial Supervisors **(ESFS):**
  - Better supervision of cross-border financial groups and improved technical standard-setting
  - Resolving disagreements and coordinated action in emergency situations
  - At the same time, reinforce the roles of colleges of supervisors. Individual firm supervision remains at the national level

EU - the new architecture

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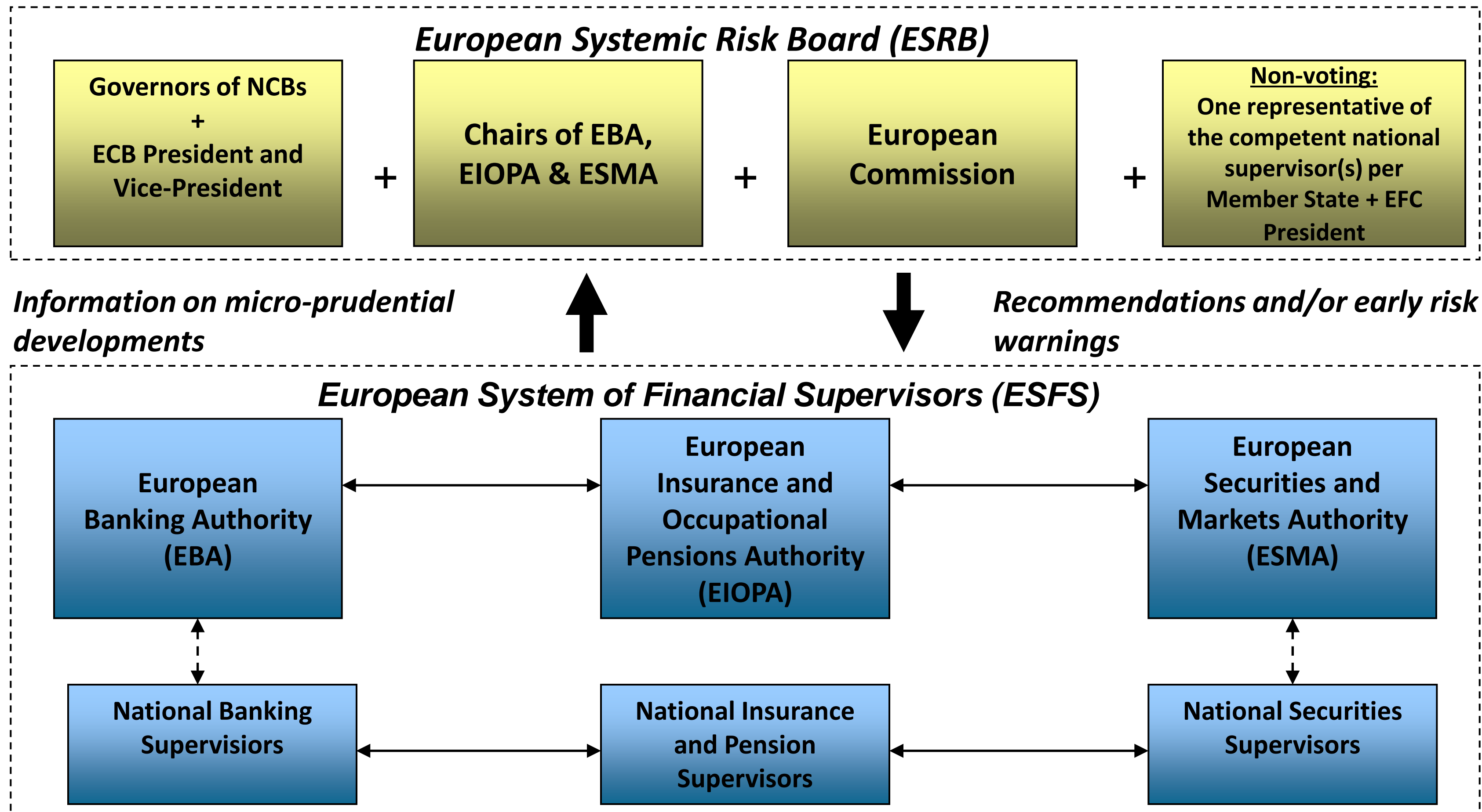

The Basel Committee on capital and liquidity

The most important part of the regulatory reform taking place, is to strenghten the resilience of the banking sector through increased capital and liquidity buffers. The Basel Committee plays a leading role in this reform.

The committee released on 17 December 2 documents :”Strengthening the resilience of the Banking sector”, and ”International framework for liquidity risk measurement, standards, and monitoring”.

- Raise the quality, consistency and transparency of the Tier 1 capital base, where the predominant form of Tier 1 capital must be common shares and retained earnings.
- Introduce a leverage ratio as a supplementary measure to the Basel II risk-based framework
- Introduce a minimum global standard for funding liquidity that includes a stressed liquidity coverage ratio requirement, underpinned by a longer-term structural liquidity ratio.

The Basel Committee on capital and liquidity

- Introduce a framework for countercyclical capital buffers above the minimum requirement.
  - Capital conservation measures such as constraints on capital distributions.
  - An appropriate set of indicators, such as earnings and credit-based variables, as a way to condition the build-up and release of capital buffers.
  - More forward-looking provisions based on expected losses.

- Issue recommendations to reduce systemic risk associated with resolution of cross-border banks

- Assess the need for a capital surcharge to mitigate the risk of systemically important banks.

In the transition to higher level and better quality of capital in banking, a setback to recovery must be avoided.

A quantitative impact study is underway. The calibration of the new requirements is planned to be completed by end-2010.

EU on liquidity and capital

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- CRD (Capital Requirements Directive) implementet in Norway as of 1 January 2007 (”Basel II”)
- Agreement on reforming and strengthening the CRD/Basel II framework (into ”Basel III”?)
- Some changes to CRD have been adopted (CRD II og CRD III).
- The EU-Commission released on 26 February 2010 its document: ”Consultation regarding further possible changes to the Capital Requirements Directive” (CRD IV). This document mirrors to a large degree the Basel documents released on 17 December.
- An EU QIS is being carried out in parallell to the Basel-QIS
- For Norwegian institutions the challenges following CRD IV is by far larger than those following CRD II and CRD III.
- There is an import reform work taking place for insurance. Solvency II is based on the same three-pillar structure as Basel II, and will take effect as of 2013.

EU on capital and liquidity

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- Already adopted changes (CRD II and CRD III), include
  - Quality of capital
  - Liquidity management
  - Strengthening of securitisation
  - Large exposures
  - Supervisory Colleges
  - Increased capital on value-at-risk models in trading portfolio
  - Increased capital on re-securitisation
  - Remuneration policies and supervisory assessment

- The changes will be transposed into national legislation as of 31 December 2010

- Finanstilsynet's proposals have been sent the Ministry of Finance on 3 March (remuneration) and on March 19 (the rest).

Why did Norway escape the worst?

- Strong macroeconomic situation, and effective measures from the authorities
- Regulation and supervision covering the entire financial market
- Strict rules for securitisation and conservative approach to hybrid capital and models.
- Robust deposit guarantee schemes
- Low exposures to structured credit, to market risk and little investment bank activities
- Banks had a relatively strong position at the start of the international crisis
- Experience among authorities and in the banking sector from the last banking crisis
- Effective cooperation between national authorities.

Norway fared better than most other countries, but also Norwegian banks faced significant challenges due to high levels of market funding.

- Finanstilsynet has signalled a possible earlier introduction of quantitative liquidity measures than what follows from the international process.
- Finanstilsynet has introduced explicit guidelines on mortgages.

Possible effects of the reform

- Banks will have to face higher requirements for liquidity buffers, for a robust funding as well as for the quality and levels of capital.

- There is a pressure for reduced leverage in the financial system. If remaining losses on securities and loans are not fully met by new capital or retained earnings, balances have to be reduced.

- Stricter regulation, reduced volume growth and losses in the pipeline will put pressure on banks' profitability, and it is not likely that return to equity will return to pre-crisis levels. At the same time, risk will probably be lower.

- Important structural changes is going on in the financial system. Some banks are out of business, while others may be kept alive due to the support measures. Some business models will not survive. The outcome of these changes is also influenced by the changes in regulation taking place. It is as of today uncertain how to meet challenges posed by the systemically important financial institutions.

- The impact of regulatory changes, both for the transition period as well as for the new equilibrium(?), is not fully assessed. This will have to include feedback effects between the financial sector and the real economy.

Summing up

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- The causes of the most serious financial crisis since the 1930s are complex and multifaceted, and involves financial institutions' risk management and governance, regulation, supervision, institutional framework for financial stability as well as macroeconomic policies.

- There is a general decreased confidence in the efficiency of financial markets, the rationality of economic agents and the self-regulating mechanisms of markets. The need for better regulation of the financial sector is recognised.

- Changes in regulation and supervision are taking place, probably towards more rules-based systems, with emphasis on strengthening capital, liquidity, governance and the international institutional framework.

- Supervision will always need discretion. There might be some changes in supervisory approaches in the direction of more emphasis on strategies and business models, and there will be more emphasis on possible effects on system risk in "traditional" supervisory work.

Summing up

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- The downward pressure on profitability in the banking sector in the years to come will be reflected in higher prices of financial services. The crisis has demonstrated once more that the cost to society of financial instability can be extremely high.

- Efficiency gains from regulatory changes to reduce systemic risk must be balanced against efficiency losses (i.e. less innovation)

- Every financial crisis is different, and it is important not only to deal with factors that created the present crisis, but also factors that could cause the next.