Countercyclical capital buffer – criteria for use and interaction with monetary policy

Speech by Governor Øystein Olsen at the annual meeting of ACI Norge (Financial Markets Association Norway) in Oslo.

The financial crisis and lessons learned

Chart: GDP, advanced economies

The financial crisis led the global economy into the most severe downturn since the Second World War. Five years after the financial crisis started in earnest, the economic repercussions are still making themselves felt. GDP in advanced economies is well below its pre-crisis trend, and unemployment in many countries has risen to alarmingly high levels.

A mechanical calculation of trend growth in the pre-crisis years probably overestimates the long-term potential growth of advanced economies. Households, businesses and governments lived beyond their means for many years. At the same time, there is little doubt that advanced economies have suffered a clear setback as a result of the crisis. Recent years' developments thus provide a good illustration of the substantial real costs that can be associated with financial crises.

Chart: Consumer price inflation in advanced economies

The financial crisis is also a useful reminder that price stability is not a sufficient condition for stability in the financial system. The 1970s and 1980s were characterised by high and variable inflation in advanced economies. Since the beginning of the 1990s, inflation has been generally low and stable. Financial imbalances built up in the same period. When the imbalances burst, the financial system was not sufficiently robust to cope with the shocks that ensued.

Well functioning banks are crucial to a modern economy. If banks' ability to provide funding, execute payments and redistribute risk is impaired, the ripple effects on the rest of society may be considerable. A framework is therefore necessary to ensure that the financial system is robust.

The financial crisis revealed shortcomings in the existing regulatory framework for banks. Not least, the crisis highlighted the need for improving macroprudential regulation and supervision. Although an individual bank might be considered solid, the overall banking system is not necessarily robust to shocks. Systemic risk can occur through several channels. Risk can build up over time through rapidly rising asset prices and debt. It can build up as a result of increased interdependence among financial institutions, or when many institutions are exposed to the same risk factors, for example on the funding side. Moreover, the expectation that governments will not allow major financial institutions to fail can encourage increased risk-taking.

To address these shortcomings, a reform of the global banking and financial regulatory framework is being introduced. New liquidity buffer and capital adequacy requirements are due for implementation in Norway in line with changes in EEA regulations. When requirements are imposed on individual banks, the overall risk in the financial system will also be taken into account. The new framework therefore contains macroprudential measures that can be applied as necessary, making the banking sector more resilient in times of rising losses and financial market distress.

Macroprudential surveillance and countercyclical buffer

The European Parliament approved a new capital adequacy framework for banks this week. The Norwegian Government presented a legislative proposal on new capital adequacy requirements for banks before Easter. The proposal is in line with the EU's new regulatory framework.

Chart: New Common Equity Tier 1 (CET1) capital adequacy requirements – phasing-in

A key element in the new framework is capital buffers that will come on top of the minimum requirement. This increases banks' loss-absorbing capacity. If banks fail to meet the buffer requirements, they will be subject to restrictions on the distribution of dividends and payments of variable remuneration. The capital conservation buffer and supplementary requirements for systemic risk and systemic importance will be permanent add-ons.

The countercyclical capital buffer will come on top as a capital requirement that can be increased in good times and removed in bad times. The countercyclical buffer is to consist of Common Equity Tier 1 capital and can normally be set between 0 and 2.5 percent of a bank's risk-weighted assets. The requirement will apply to all banks operating in Norway, including foreign subsidiaries and branches.

The capital adequacy requirements stipulate how much capital banks are required to hold as a share of risk-weighted assets. The lower the risk weights, the less capital the banks will be required to hold. The regulations and methods used to set risk weights are thus important for determining the level of capital banks must hold. The Government has announced that changes will also be made in this area.

The Storting (Norwegian parliament) will consider the Government's legislative proposal on new capital adequacy requirements before summer. The Ministry of Finance will subsequently draw up a regulation that gives Norges Bank primary responsibility for elaborating the basis for decisions on the countercyclical capital buffer. In drawing up the basis, the Bank will collaborate and exchange relevant information with Finanstilsynet (Financial Supervisory Authority of Norway). The buffer will be set by the Ministry of Finance. Once the regulation has been drawn up, most likely over summer, Norges Bank will issue concrete advice on the buffer level. Thereafter, the Bank will present an updated assessment and advice on the buffer four times a year. The Bank's advice will be based on three criteria.

Chart: Criteria for an appropriate countercyclical buffer

- The first criteria states that the buffer should be increased when financial imbalances build up to strengthen their resilience during periods of rising losses.
- The second criteria states that the size of the buffer must be viewed in the light of other requirements applying to banks, particularly when new requirements are introduced.
- The third criteria will apply when the buffer is turned off. Banks will be allowed to draw on the buffer in the event of an economic downturn or rising bank losses. This will contribute to counteracting the procyclical effects of tighter bank credit standards. The capital buffer will thereby contribute to enhancing economic stability.

The capital buffer should not be reduced automatically even if there are signs that financial imbalances are receding. After a period of high risk and an increased countercyclical buffer, maintaining the buffer is likely to entail relatively small costs to banks. The advantages of maintaining a buffer could prove to be considerable.

Identifying financial imbalances is demanding in practice. However, economic theory and our experience of previous crises can provide guidance.

Chart: Key indicators for the countercyclical capital buffer

Norges Bank's advice on the countercyclical capital buffer will primarily be based on four key indicators. The four indicators include credit growth, house and commercial property prices and banks' wholesale funding. The Norwegian banking crisis at the beginning of the 1990s and the 2008 financial crisis are marked in the chart. The four indicators showed clear signs of rising ahead of both crises. This has also been the case ahead of crises in other countries. The four indicators combined can provide signals of a build-up of financial imbalances. The Bank will analyse developments in the key indicators and compare the current situation with historical values. The indicators with trends and historical averages are shown in the chart. There will not be a mechanical relationship between the indicators and Norges Bank's advice on the countercyclical capital buffer. The advice will also be based on the Bank's professional judgement.

The key indicators are not well suited to signalling when the buffer requirement should be reduced. We will need information that will quickly convey the state of financial markets and banks' balance sheets.

Financial crises tend to follow a period of a mutually reinforcing increase in credit and property prices over a longer period. When the bubble bursts, the same driving forces that contributed to the imbalances may amplify an economic downturn.

In Norway, credit and asset prices have risen over a number of years, and total debt has reached a high level. House prices and debt continue to rise more rapidly than incomes. At the same time, households are saving more, although debt and assets are unevenly distributed. Around one tenth of households hold debt equivalent to five times their income. This is higher than in the years preceding the Norwegian banking crisis. Households with a high level of debt also hold small financial buffers. They may face problems servicing their debt if interest rates rise or incomes fall. A number of them may have to pare back other

consumption. This will have ripple effects on the wider economy and banks may face higher losses on corporate lending as a result.

Rapid lending growth has often coincided with rising levels of wholesale funding among banks. There may be a number of reasons for this. One reason is that it is difficult to match lending growth and deposit growth. Furthermore, ample access to favourable wholesale funding can provide incentives for banks to increase lending volumes, which often involves taking higher risk. It is often difficult to sustain lending growth when markets shrink in turbulent times. In the period to the financial crisis in 2008, the share of wholesale funding rose among Norwegian credit institutions, and dysfunctioning financial markets was one of the primary reasons for banks' funding problems.

The countercyclical capital buffer is intended to counteract the procyclical effects of bank lending. The buffer will help contain the degree of deleveraging in bad times. But an increase in the buffer can also contain rapid credit growth in good times. The effect will depend on banks' reaction to an increase in the buffer requirement.

Chart: Ways for banks to boost capital ratios

There are roughly two ways for banks to boost capital ratios.

First, a bank can raise additional capital. Bank owners can contribute by participating in equity issues or by accepting a smaller share of the profit distributed as dividend. Bank funding costs will increase to the extent that equity- financed lending is more expensive than other forms of financing bank lending. If banks choose to increase their lending margins to boost earnings, an increase in the buffer may curb credit demand.

Second, banks can increase capital ratios by reducing risk-weighted assets. If banks choose to curb lending growth, credit growth will be affected directly. Banks can also reduce risk-weighted assets by shifting to loans with a lower risk weight. This may result in higher growth in household lending in tandem with a tightening of corporate lending standards.

A higher capital to loan ratio will not necessarily increase bank funding costs. In finance theory, a well known theorem states that the cost of funding is unaffected by the structure of funding. However, a number of factors would indicate that this does not fully hold for banks. One factor is that deposit insurance protects a majority of depositors against losses. Moreover, the banks' largest creditors expect the government authorities to prevent big bank failures. There is nevertheless reason to believe that the increase in costs will be fairly small in the long term. The cost associated with raising the Common Equity Tier 1 requirement by 2.5 percentage points is roughly estimated at an increase in lending margins of 20 basis points. It should also be noted that the cost of holding equity depends on the rate of return required by investors. When the return on equity becomes safer, it should also become lower.

Chart: Bank interest margins

Banks have already stated that they are adapting to higher capital requirements. They are well poised to build up buffers. Banks' lending rates remained high in 2012 despite a fall in

their borrowing costs. This contributed to solid earnings. In addition, bank losses are for the time being at a low level and dividend payout ratios were lower than in previous years.

Chart: Common Equity Tier 1 capital ratio at year-end

Almost all the large Norwegian banks increased their capital ratios in 2012. All Norwegian banks satisfy the new capital adequacy requirement of 9 percent, to apply from 1 July this year. They are also well positioned to satisfy the 10 percent requirement, to apply from 1 July next year. On top of this will be added supplementary requirements for systemic importance and a countercyclical buffer requirement. The banks must therefore continue to build capital.

The new capital adequacy framework for banks will be introduced simultaneously in a number of countries. The EU will allow a gradual phasing-in of some of the permanent requirements, but also provides scope for accelerated phasing-in. The countercyclical capital buffer is part of the new framework, although its size will vary across countries. While several of our European neighbours are still struggling with low economic growth and weak banks, Norway is experiencing high credit growth and rapidly rising house prices, and banks are posting solid earnings. Against this background, Norway can be among those countries that rapidly phase in the new regulations. We can also be among the first to apply the countercyclical capital buffer requirement.

The result, once the new regulatory framework has been fully implemented, will be more resilient banks. This will benefit us all.

Monetary policy outlook

In Norway, monetary policy is oriented towards keeping inflation low and stable. The operational target is annual consumer price inflation of close to 2.5 percent over time. Norges Bank operates a flexible inflation targeting regime so that weight is given to both variability in inflation and variability in output and employment.

The response pattern of monetary policy can be summarised in three criteria for an appropriate interest rate path.

Chart: The monetary response pattern and criteria for an appropriate interest rate path

The first criterion states that the key policy rate should be set with a view to stabilising inflation at target or bringing it back to target after a deviation has occurred. Inflation is now low and there are prospects that it may take time for inflation to pick up. Low external price impulses and a strong krone are contributing to holding the rise in prices for imported consumer goods at a low level. The rise in prices for domestically produced goods and services is also moderate. Wage growth is being restrained by high labour immigration and low wage growth in surrounding countries. Rising capacity utilisation may push up cost and price inflation further ahead, but as noted in the March *Monetary Policy Report* we now believe that this will occur further out than projected earlier.

Chart: Inflation

The objective of returning inflation to target suggests, in isolation, a lower key policy rate, but this must be weighed against the aim of output and employment stability. The interest rate path should provide a reasonable balance between the path for inflation and the path for overall capacity utilisation in the economy. This is implied by the second criterion, which is that the inflation targeting regime is flexible.

Chart: Capacity utilisation

Capacity utilisation in the Norwegian economy is now above a normal level, and prospects for fairly solid growth suggest that it may edge up ahead. Growth is being supported by vigorous activity in oil-related industries, while housing investment is expanding rapidly partly owing to high population growth. On the downside, there are prospects of weak growth in the non-oil export sector. External demand is weak and cost inflation is projected to remain higher in Norway than among our trading partners.

The aim of stable output and employment in the Norwegian economy suggests, in isolation, a somewhat higher key policy rate, as does the third criterion for an appropriate interest rate path which is that monetary policy should be robust and mitigate the risk of a build-up of financial imbalances.

Among other things, it has been argued that a low interest rate over time may lead to excessive risk-taking by banks and households. The criterion that monetary policy should be robust therefore suggests that we should avoid an abnormally low interest rate over a long period.

Chart: The interest rate path with different criteria

Models are useful tools for systematising information and assessments, and for ensuring consistency over time, but will always be a simplification of reality. Our projections are thus based on a combination of model analyses and professional judgement. The chart shows an alternative interest rate path had weight only been given to reaching the inflation target, that is to say the first criterion. According to the model analysis, the key policy rate should then have been lowered rapidly and kept close to zero for some time. On the other hand, the aim that monetary policy should not result in excessive fluctuations in output and employment and the aim of a robust monetary policy suggest a higher key policy rate. On the basis of an overall assessment, the Executive Board concluded at the monetary policy meeting in March that it was appropriate to set the key policy rate so that it takes somewhat longer than earlier for inflation to move back to the target of 2.5 percent.

Monetary policy and financial stability

Chart: Front page of the March 2013 Monetary Policy Report - with financial stability assessment

When Norges Bank is to issue advice to the Ministry of Finance on a countercyclical capital buffer requirement for banks, it raises the question of how this instrument will be taken into account in the conduct of monetary policy.

Norges Bank will present analyses and issue advice on the size of countercyclical capital buffer in conjunction with the decision basis for monetary policy. The aim is to ensure that the analytical basis is consistent with the formulation of monetary policy.

The objectives of the countercyclical capital buffer and the key policy rate are different. The objective of the buffer is to strengthen banks' resilience to losses in an economic downturn, while the objective of monetary policy is low and stable inflation over time. The inflation target is weighed against the aim of smoothing fluctuations in output and employment.

Even though the objectives differ, both the key policy rate and the buffer work through banks' responses. The buffer will be set on the basis of an assessment of the risk that financial imbalances build up and trigger or amplify an economic downturn. Capital adequacy requirements, and their effect on bank interest margins, will be one of many factors underlying the monetary policy analysis. Buffer decisions will be based on an assessment of the current situation in the Norwegian economy, with particular weight on various credit and asset prices.

Even though the regulatory framework for new capital requirements will not be in place until later this year and phased in gradually, the effects have already come into evidence. As part of its conduct of monetary policy, Norges Bank continuously monitors banks' responses to the new regulations.

The countercyclical capital buffer will strengthen the resilience of the banking sector during an upturn. It may also, to some extent, counteract the build-up of financial imbalances. But the effect is uncertain. Thus, Norges Bank cannot disregard taking financial imbalances into consideration when setting the key policy rate. The criteria for the conduct of monetary policy remain firm also after the introduction of a countercyclical capital buffer.

Thank you for your attention.