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# NORWAY

## FINANCIAL SECTOR ASSESSMENT PROGRAM

## TECHNICAL NOTE—BANKING REGULATION AND SUPERVISION

August 2020

This Technical Note on Banking Regulation and Supervision for the Norway FSAP was prepared by a staff team of the International Monetary Fund as background documentation for the periodic consultation with the member country. It is based on the information available at the time it was completed on July 7, 2020.

**Disclaimer:**
This document was prepared before COVID-19 became a global pandemic and resulted in unprecedented economic strains. It, therefore, does not reflect the implications of these developments and related policy priorities. We direct you to the **IMF Covid-19 page** that includes staff recommendations with regard to the COVID-19 global outbreak.

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# NORWAY

July 24, 2020

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# TECHNICAL NOTE

## BANKING REGULATION AND SUPERVISION

This Technical Note was prepared in October 2019, before the global intensification of the COVID-19 outbreak. It focuses on Norway's medium-term challenges and policy priorities and does not cover the outbreak or the related policy response, which has since become the overarching near-term priority.


Prepared By
**Monetary and Capital Markets Department**


This Technical Note was prepared by IMF staff in the context of the Financial Sector Assessment Program in Norway. It contains technical analysis and detailed information underpinning the FSAP's findings and recommendations. Further information on the FSAP can be found at
http://www.imf.org/external/np/fsap/fssa.aspx

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# Glossary

| | |
|---|---|
| AML/CFT | Anti-Money Laundering and Countering the Financing of Terrorism |
| BCBS | Basel Committee on Banking Supervision |
| BIS | Bank for International Settlements |
| BOD | Board of Directors |
| CAR | Capital Adequacy Ratio |
| CET1 | Common Equity Tier 1 |
| CCyB | Counter Cyclical Capital Buffer |
| CRD | Capital Requirements Directive |
| CRE | Commercial Real Estate |
| CRR | Capital Requirements Regulation |
| DSIB | Domestic Systemically Important Bank |
| DSTI | Debt Service to Income Ratio |
| DTI | Debt-to-Income Ratio |
| EBA | European Banking Authority |
| ECB | European Central Bank |
| EEA | European Economic Agreement |
| EFTA | European Free Trade Association |
| EIOPA | European Insurance and Occupational Pensions Authority |
| ESMA | European Securities and Markets Authority |
| EU | European Union |
| EUR | Euro |
| FATF | Financial Action Task Force |
| FIU | Financial Intelligence Unit |
| FSA | Finanstilsynet |
| FSAP | Financial Sector Assessment Program |
| FTE | Full-Time Equivalent |
| GDP | Gross Domestic Product |
| GFC | Global Financial Crisis |
| HHI | Herfindahl Hirschman Index |
| ICAAP | Internal Capital Adequacy Assessment Process |
| ICT | Information and Communication Technology |
| IFRS | International Financial Reporting Standards |
| IMF | International Monetary Fund |
| IRB | Internal Ratings Based Approach |
| LCR | Liquidity Coverage Ratio |
| LGD | Loss Given Default |
| LTV | Loan-to-Value Ratio |
| ML/TF | Money Laundering and Terrorist Financing |
| MoF | Ministry of Finance |
| MoU | Memorandum of Understanding |
| NBFI | Non-Bank Financial Intermediary |

| | |
|---|---|
| NOK | Norwegian Krone |
| NPL | Nonperforming loans |
| NSFR | Net Stable Funding Ratio |
| PD | Probability of Default |
| RWA | Risk-Weighted Assets |
| SEBRA | System for EDP-based Accounts Analysis |
| SME | Small and Medium-sized Enterprise |
| SRB | Systemic Risk Buffer |
| SREP | Supervisory Review and Evaluation Process |
| SRV | General Risk Assessment |
| USD | United States Dollar |

# EXECUTIVE SUMMARY

**This note presents a targeted review of selected aspects in the regulation and supervision of banks in Norway.** The review is carried out as part of the 2020 Norway Financial Sector Assessment Program (FSAP) and the findings and recommendations are based on the regulatory framework in place and the supervisory practices employed at end-October 2019. The note focuses on the powers and responsibilities, independence, and resourcing of Finanstilsynet (FSA); its supervisory approach and enforcement powers and practices; key aspects of the prudential framework; and mechanisms to prevent abuse of financial services.

**The FSA has thorough oversight processes and supervisory tools, but there is scope for enhancement in some areas.** In recent years, the oversight framework has been strengthened by means of higher regulatory requirements for banks' capital; limits on banks' credit risks, particularly in real estate lending; updates to supervisory modules; development of supervisory risk assessment tools; a new legal framework for Anti-Money Laundering and Countering the Financing of Terrorism (AML/CFT); and some expansion in supervisory resources. However, strengthening the powers, operational independence, and budgetary autonomy of the FSA represents a key element to enhance the effectiveness of banking supervisory activities. The supervisory approach could also be more focused on banks' risk profiles, which would increase supervisory activities over medium and small banks (especially those with high-risk profiles) as well as systemic branches of foreign banks. The FSA could also strengthen its oversight of banks' risk management practices, particularly for credit and liquidity risks.

**While the FSA is responsible for the supervision of the financial sector, the Ministry of Finance (MoF) plays a major role in financial regulation and in various operational supervisory issues.** The MoF sets key prudential regulations and has the power to issue and withdraw bank licenses (although this is delegated to the FSA in some cases). In addition, the MoF sets annual goals for the FSA and has the power to issue instructions to the FSA. While these goals are usually discussed and agreed with the FSA, some goals and instructions may not fully align with the FSA's priorities and resources. In addition, the MoF can overturn the FSA's decisions through an appeal process available to the financial industry. While the FSA's expenses are financed by levies on supervised institutions, its budget is subject to the direct control of the MoF, which limits its ability to increase resources in line with needs and priorities.

**To help the FSA achieve its supervisory objectives, the authorities are advised to strengthen the FSA's powers and independence and increase its budgetary autonomy.** The FSA should be granted powers to issue binding regulations (in micro-prudential areas) and to decide on bank licenses and their withdrawal. In addition, the powers given to the MoF to issue instructions and decide on appeals to supervisory decisions should be reconsidered since they could impair the ability of the FSA to effectively fulfill its supervisory mandate. More budgetary autonomy for the FSA and a higher level of accountability would allow it to manage and control its resources more effectively. Enhancing the FSA powers and its operational and budgetary independence would

greatly enhance the ability of the FSA to address other findings in this note, particularly those related to the FSA supervisory approach and intrusiveness.

**While the FSA has a robust supervisory approach, focused mostly on large and systemic banks, a greater consideration of banks' risk profiles is warranted.** The FSA has made progress in increasing its regular offsite analysis for medium and small banks since the last FSAP, but the focus of its supervisory activities, including onsite inspections and interaction with banks' management, remains mostly on systemic and large banks. Such an approach is understandable given the systemic implications of these banks. However, a more risk-oriented approach could ensure better visibility of risks and trends and greater consideration of both banks' size and risk profile in planning and prioritizing supervisory activities, which would allow an increased level of onsite inspection for medium and small banks.

**There is scope to strengthen monitoring and supervision of systemic branches of foreign banks in Norway.** There is a well-established framework for cross-border supervisory cooperation with the home authorities of foreign banking entities, including in the form of supervisory colleges. Notwithstanding the FSA's active involvement in cross-border supervisory activities, it may be useful to increase its monitoring and direct supervision of foreign bank branches that are systemically relevant in Norway, particularly if they receive a low level of scrutiny by the home supervisors due to their lower relevance for the group or the home jurisdiction.

**The Norwegian banking system is well capitalized, and the regulatory capital framework is consistent with and in some ways exceeds the minimum Basel III standards.** Banks' capital adequacy has improved steadily since 2008 and all Norwegian banks maintain risk-based capital and leverage ratios above the minimum requirements (including capital buffers). Strong asset quality, stable and sustained profitability, and retention of earnings have contributed to banks' strong capital buffers.

**The authorities should determine and monitor the implications of the adoption of the European Union (EU) rules on banks' capital and continue their actions to maintain strong capital levels.** Norway's forthcoming adoption of the EU framework (as part of the EEA agreement) will limit the authorities' room to maintain more rigorous standards and weakens some of the existing requirements. In particular, removing the Basel I floor and introducing the small and medium-sized enterprise (SME) supporting factor will reduce the banks' capital requirements. The authorities have made clear that the adoption of the EU framework shall not reduce the capital levels in Norwegian banks. The authorities are encouraged to use the available tools, including Pillar 1 and Pillar 2 measures, to maintain Norwegian banks' capital levels. In particular, limited data for estimation and validation of IRB models and reduced risk weights over time suggest that stricter model calibration requirements are needed. In addition, the FSA should continue to provide banks with a transparent and detailed description of its Pillar 2 approach and decisions.

**The authorities should continue to enhance the regulatory framework for banks' credit risk and strengthen oversight of related systems and models.** Credit risk, particularly in real estate lending, is the predominant risk exposure among Norwegian banks. The FSA should develop supervisory guidance on prudential aspects of loan loss provisioning and the valuation of real estate.

Temporary prudential regulations governing residential real estate lending should be made permanent as these measures address structural risks and seem to have successfully dampened debt growth and house price inflation. The dearth of historical loan loss data for banks using the Internal Ratings-Based (IRB) approach for credit risk warrants continued enhancements in oversight of banks' modeling and risk management practices for real estate lending. The authorities should also develop supervisory guidance on commercial real estate (CRE) exposures to supplement their intensified supervisory scrutiny of this asset class.

**There is scope to strengthen prudential oversight of banks' liquidity beyond monitoring of compliance with the Liquidity Coverage Ratio (LCR) requirement.** The Net Stable Funding Ratio (NSFR), currently reported by banks, should be introduced as a requirement according to the EU framework timeline. Given banks' reliance on the swap market to hedge their considerable foreign currency funding, the FSA could conduct foreign currency liquidity stress tests to check the banks' resilience to shocks in the derivatives markets. Banks' reliance on covered bonds to meet liquidity and funding requirements, and the implications of the more lenient treatment of such instruments in the EU LCR framework, warrants increased oversight of liquidity risk management especially due to cross-holdings of these bonds among banks and their correlation with the real estate market.

**While the FSA has made progress in strengthening its AML/CFT supervisory approach, there is scope to continue expanding supervisory resources and activities in this area.** The FSA should seek to increase its AML/CFT onsite inspections of banks, including branches of foreign banks, particularly in the form of targeted and thematic inspections. It should also continue to use the new sanctioning powers under the new AML act and review their effectiveness, with a view to ensure a more active approach in dealing with banks' AML/CFT weaknesses and deficiencies. In addition, the FSA could further improve its risk-based approach to AML/CFT by enhancing its risk classification model to ensure its reliability as an indicator of ML/TF risks and by developing its AML/CFT supervisory tools and methodologies.

**Norway's legal framework for related party transactions has been updated to correct previously identified deficiencies, but further improvements are needed.** The framework has been updated to include a revised definition of related parties. However, this new definition still does not include shareholders unless they have controlling interests. Also, the framework now requires transactions with related parties to be in accordance with ordinary business terms between independent parties. It is limited however in that it specifies only credit and guarantees.

| Table 1. Norway: Key Recommendations | |
|---|---|
| **Recommendations and Authority Responsible for Implementation** | **Time[1]** |
| ***Supervisory Objectives, Powers, Independence, and Resources*** | |
| Empower the FSA to issue prudential regulations, and to decide on: granting/ withdrawal of bank licenses, transfers of significant ownership, and major acquisitions. (MoF, Government; ¶16, 19, 27) | ST |
| Limit the powers of the MoF to issue instructions to the FSA and decide on appeals to the FSA supervisory decisions and measures. (MoF, Government; ¶18, 23, 27) | ST |
| Give the FSA more budgetary autonomy to ensure that it has enough resources to carry out its mandate effectively. (MoF, Government; ¶24–26, 27) | ST |
| **Supervisory Approach and Processes, and Corrective Actions** | |
| Further consider banks' risks in planning supervisory activities and increase the frequency of onsite inspections of medium and small banks with high risks. (FSA; ¶30, 32, 33, 39) | I |
| Strengthen monitoring and supervision of systemic foreign bank branches. (FSA; ¶34, 36, 39) | ST |
| Continue to advance work on banks' recovery and resolution planning, particularly for systemic and large banks. (FSA; ¶37, 39) | MT |
| Grant the FSA legal powers to apply significant fines and sanctions in case of banks' breaches of legal and prudential requirements. (MoF, Government; ¶43, 45) | ST |
| **Prudential Framework and Regulations** | |
| Develop specific guidance on prudential aspects related to loan loss provisioning and the valuation of real estate. (FSA; ¶57, 70, 71) | I |
| Continue oversight of banks' models and risk management of real estate loans. (FSA; ¶64, 71) | I |
| Develop specific guidance on CRE exposures and their risk management. (FSA; ¶67, 71) | I |
| Expand the legal definition of related parties to include all significant shareholders and the scope of the related party framework to include all transactions with related parties. (MoF, FSA; ¶72, 76) | MT |
| Introduce NSFR requirements and continue NSFR reporting in significant currencies. (MoF, FSA; ¶79, 83) | ST |
| Monitor the implications of the transposition of the EU rules on banks' capital and take actions to maintain strong capital levels (MoF, FSA; ¶56) | I |
| Monitor banks' reliance on covered bonds in their liquidity and funding, and ensure they have adequate liquidity buffers. (FSA; ¶80, 83) | I |
| Perform more frequent targeted and thematic reviews of banks' liquidity and funding management. (FSA; ¶81, 83) | I |
| Expand operational risk guidance and oversight to take greater account of non-ICT operational risk management. (FSA; ¶89, 91) | ST |
| **Financial Integrity** | |
| Increase the frequency of AML/CFT targeted and thematic onsite inspections. (FSA; ¶95, 98) | I |
| Further improve the risk-based approach to AML/CFT supervision by enhancing the risk rating model and developing relevant supervisory tools and methodologies. (FSA; ¶93, 98) | I |

[1] I Immediate (within 1 year); ST Short term (1-3 years); MT Medium Term (3-5 years)

# INTRODUCTION[1]

## A. Scope and Approach

**1. This note presents a targeted review of selected aspects concerning the regulation and supervision of banks in Norway.** The review was carried out as part of the 2020 Norway Financial Sector Assessment Program (FSAP) and the findings and recommendations were based on the regulatory framework in place and the supervisory practices employed at end-October 2019. They were also informed by insightful discussions with the authorities in Oslo, namely Finanstilsynet (FSA) and the Ministry of Finance (MoF). The team also held discussions with Finance Norway, and several banks and external audit firms in Norway.

**2. The mission focused on selected issues based on their macro-financial relevance and on previously identified weaknesses in the Norwegian regulatory and supervisory framework.** The main themes included: the powers and responsibilities, independence, and resourcing of the FSA as it relates to banking regulation and supervision; the supervisory approach and tools to assess banking risks and conduct supervisory oversight of banks in Norway; and the enforcement and sanctioning powers and practices of the FSA. The note also covers key aspects of the prudential and supervisory framework applicable to banks, particularly in relation to capital adequacy, credit risk, related party transactions and large exposures, liquidity and funding risks, operational risk, market risk, and abuse of financial services.

**3. The FSAP team wishes to thank the authorities and private sector participants for their excellent cooperation.** The FSA provided a partial self-assessment of compliance with the 2012 Basel Core Principles and responses to a complementary questionnaire. The authorities also provided examples of actual supervisory practices and assessments. The team benefitted greatly from the inputs received and exchanges of views during meetings with supervisors, banks, industry associations, external auditors, and other market participants. The team would like to also thank the authorities for the excellent arrangements that have greatly facilitated the work of the mission.

**4. This note is structured as follows.** The next two sections of this part discuss the market structure of banks in Norway, including a brief overview of their prudential indicators, and the institutional setting for banking regulation and supervision. The following parts discuss respectively: the FSA supervisory objectives, powers, and resources; the supervisory approach employed by the FSA and the corrective action regime for banks; the prudential regulatory framework applicable to banks (capital adequacy requirements, credit risk, large exposures and related party transactions, market and liquidity risks, and operational risk). The last part discusses the regulatory framework and supervisory practices related to abuse of financial services, particularly in relation to anti-money laundering and countering the financing of terrorism (AML/CFT).

[1] Prepared by Rachid Awad (IMF) and William Coen (IMF external expert), with contributions from Maksym Markevych (IMF) for the section on financial integrity.

## B. Market Structure

**5. The Norwegian financial sector is dominated by credit institutions.** Financial sector assets totaled 270 percent of GDP at the end of 2018. The sector comprises banks (52 percent of financial assets); mortgage and finance companies (25 percent), insurers (19 percent), and state-lending institutions (4 percent). There were 141 banks in Norway, of which 125 were domestic banks, two subsidiaries of foreign banks and 14 branches of foreign banks. Of the domestic banks, 97 are savings banks and the rest are commercial banks. Branches of foreign banks account for 35 percent of the banking system's assets and some of them are systemically important. Following the "branchification" of the second largest bank in 2017, three of the four largest banks in the Norwegian market are now branches of foreign banks. The largest banks and insurance companies are part of financial conglomerates.

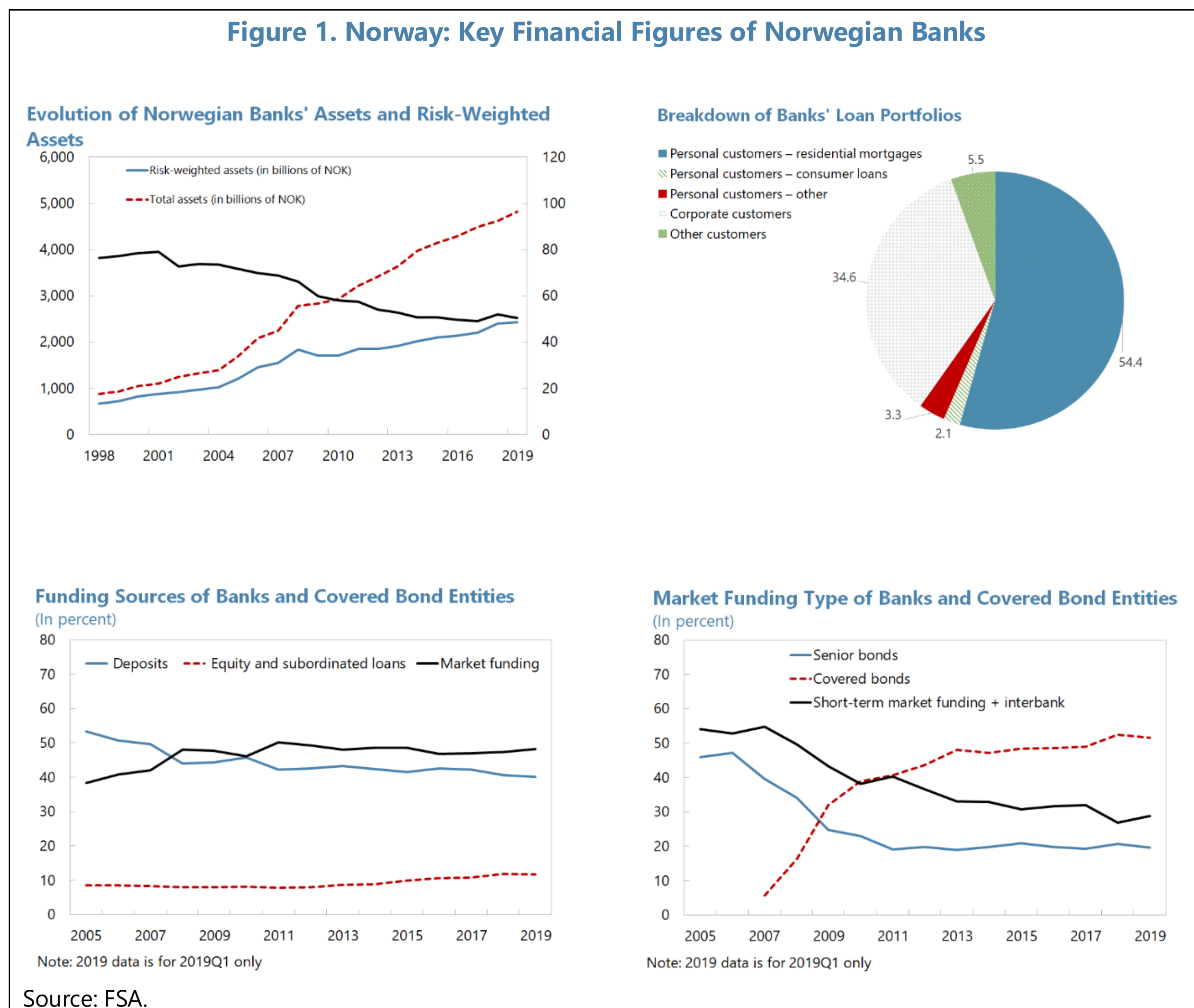
**6. Banks' capital adequacy has been increasing and their profitability has been steady over the years.** Norwegian banks' financial position has improved as a result of several years of strong profits and profit retention. The Common equity Tier 1 (CET1) capital adequacy ratio more than doubled during the period to reach 16.1 percent at end-March 2019. Pre-tax profits rose further in 2018 to the same level as in the years prior to the international financial crisis, to reach 1.26 percent of average total assets. Return on equity has remained overall stable to reach 11.5 percent during the same period.

**7. Banks have high exposures to the real estate sector.** Retail lending represents 60 percent of the banks' total lending, of which 91 percent consists of residential mortgages and 4 percent of unsecured consumer loans. Despite the low share of unsecured consumer loans, their growth has far outstripped general credit growth. Commercial real estate (CRE) lending constitutes a significant portion of loans to domestic corporate customers reaching 40 percent at the end of 2018. Foreign bank branches have a relatively higher market share in corporate lending and lower share in retail lending. Asset quality is generally high, with nonperforming loans (NPLs) of below one percent and good provisioning levels. However, NPLs in the unsecured consumer lending sector have been increasing to reach 8 percent of the consumer lending portfolio at end-June 2019.

**8. High real estate valuations and the rising household leverage increase banks' risks and vulnerabilities in the event of a housing price correction or an economic reversal.** The overall residential real estate price index for Norway has risen by 70 percent over a 10-year period (with higher appreciation in Oslo) and CRE prices have risen by about 60 percent over the past decade. Norwegian households have a high level of debt relative to disposable income compared with many other countries. At the end of 2018, the average debt burden of Norwegian households was 231 percent, up 3 percentage points from the previous year.

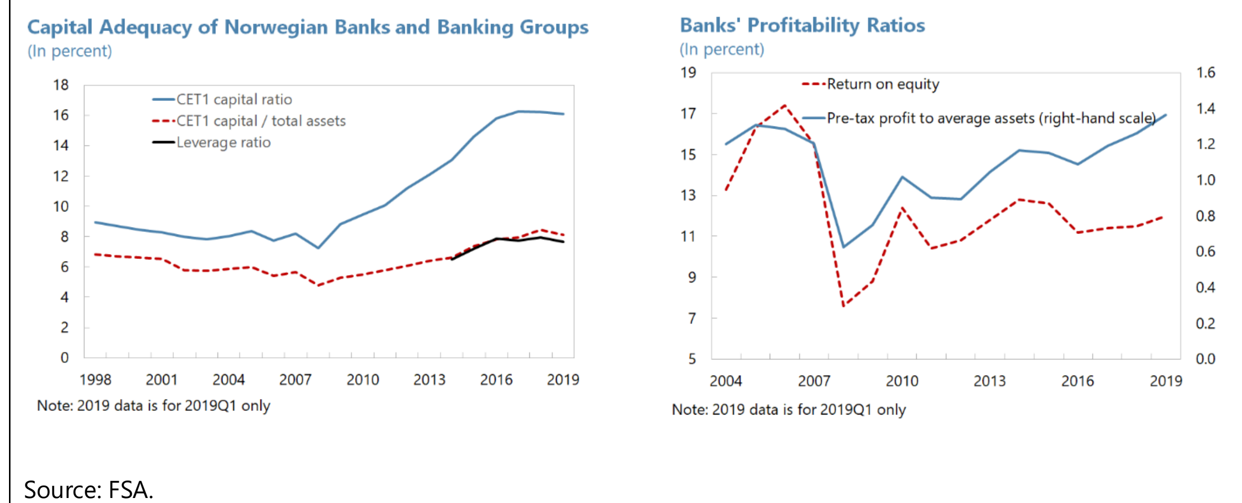
**9. While Norwegian banks rely significantly on market funding, their long-term funding and liquidity buffers have increased since 2008.** Market funding and customer deposits represented respectively 48 percent and 40 percent of total funding at end-March 2019. The share of market funding has been stable in recent years. Banks' market funding consists of senior bonds, covered bonds and short-term market funding including interbank debt. Covered bonds have become an ever more important source of funding and accounted for about half of the market funding at end-March 2019. Increased use of covered bonds has contributed to more stable funding with longer maturities at favorable prices. At the same time, covered bonds account for a significant part of banks' liquid assets (29 percent at end-March 2019). This high proportion of covered bonds, both as a funding source and liquidity reserve, results in systemic risk due to cross-ownership among banks as well as due to the interlinkages between these bonds and the housing market.

**Figure 1. Norway: Key Financial Figures of Norwegian Banks**




Source: FSA.

**Figure 2. Norway: Banks' Capital Adequacy and Profitability**




Source: FSA.

## C. Institutional Setting

**10. Norwegian rules governing financial institutions are largely derived from EU legislation, with most banking regulations being issued by Ministry of Finance (MoF).** As a member country of the European Economic Area (EEA), Norway transposes European regulations and directives into Norwegian legislation once those are incorporated into the EEA agreement, which in some cases requires an adaptation by a Joint Committee decision. Draft laws are proposed by the MoF and approved by the Cabinet (King in Council) then submitted to the Parliament. Powers to issue regulations are usually given to the Cabinet by laws, but in the area of banking are often delegated to the MoF. In some cases, they are further delegated to the FSA, mostly in the form of circulars providing guidance to banks. The MoF also exercises licensing powers for larger banks and is effectively the court of appeal for complaints against the FSA.[2]

**11. The Financial Supervision Act designates the FSA as the financial sector supervisor in Norway.** The FSA is a government agency that builds on laws and decisions emanating from the Parliament (Storting), the Government and the MoF and on international standards for financial supervision and regulation. The FSA is responsible for supervision of, inter alia, banks and, other credit institutions, payment institutions, insurance companies, pension funds, securities and investment firms, and audit firms. The FSA is the resolution authority in Norway but decisions of significance for financial stability are taken by the MoF. The FSA is also charged with ensuring that supervised entities safeguard the interests and rights of consumers (Section 3 of the Financial Supervision Act).

[2] See next section for more details on supervisory powers and objectives.

**12. There are other institutions that play a role in the oversight of the financial system and in promoting its safety and soundness.** Norges Bank is the country's central bank and its purposes and functions are set out in section 1–2 of the Central Bank Act. Norges Bank's objectives include maintaining monetary stability as well as promoting stability of the financial system and an efficient and secure payment system. Based on this act, Norges Bank has an executive and advisory authority for monetary policy and promotion of financial stability. It also acts as a lender of last resort. The Bank may further introduce measures that are common or natural for a central bank. However, Norges Bank shall inform the ministry about matters of importance. Økokrim is the Norwegian national authority for investigation and prosecution of economic and environmental crime and is Norway's Financial Intelligence Unit (FIU).

**13. Important bank legislation changes have been enacted over the last few years.** A new Financial Institutions Act entered into force in January 2016 and is primarily a continuation and extension of previous legislation. The act regulates the operations of financial institutions. It sets requirements for the establishment, operation, and wind-up of financial undertakings. In March 2018, the Storting (Parliament) passed the Act on the Norwegian Banks' Guarantee Fund and the Act on amendments to the Financial Institutions Act. Both acts entered into force in January 2019. The enactments transpose the EU's Bank Recovery and Resolution Directive and the Deposit Guarantee Directive. In October 2018, a new AML act and regulation came into force. The AML/CFT legal framework underwent amendments to transpose relevant EEA legislation based on the EU's fourth and parts of the fifth AML Directive (directive 2015/849). It also implements a number of the Financial Action Task Force (FATF) recommendations on measures against money laundering and terrorist financing.

# SUPERVISORY OBJECTIVES, POWERS, INDEPENDENCE, AND RESOURCES

## A. Supervisory Objectives and Powers

**14. The objectives of the regulatory and supervisory authorities are defined in various legal texts.** Section 3 of the Financial Supervision Act assigns to the FSA the responsibility of ensuring that supervised entities operate in an appropriate and proper manner in accordance with law and provisions laid down pursuant to law. The objectives and responsibilities of Norges Bank, as set in the Norges Bank Act, include playing the role of an executive and advisory body for monetary, credit, and foreign exchange policy. Norges Bank also acts as a lender of last resort and promotes an efficient payment system.

**15. The FSA and Norges Bank share some responsibilities, which necessitates thorough coordination to avoid overlaps.** While the MoF is the macroprudential authority, both the FSA and Norges Bank advise on macroprudential measures. Norges Bank and the FSA both also publish financial stability reports. For the FSA, the financial stability analysis aims at conducting a more effective risk-based supervision, monitoring macroeconomic developments and systemic trends, and

evaluating and recommending macroprudential measures. Both Norges Bank and the FSA also have supervisory responsibilities in the payment system. The FSA supervises individual institutions while Norges Bank has responsibility for the whole system in addition to its oversight of settlement and clearing.

**16. While the FSA is responsible for the supervision of the financial sector, the MoF plays a major role in financial regulation.** The MoF is responsible for setting minimum key prudential requirements. The Financial Institutions Act sets out prudential requirements in broad terms (e.g., capital requirements, large exposures, liquidity, etc.), but gives the MoF the powers to set prudential regulations in these various areas. The FSA is effectively charged with assessing banks' risks and enforcing the laws and regulations set by the MoF. The FSA has limited prudential powers (stipulated by the Financial Institutions Act or delegated from the MoF) such as issuing regulations in the areas of accounting, external and internal audit and control, outsourcing, and reporting. The FSA is often asked by the MoF to prepare or propose new regulations, but the final regulation approved by the MoF does not always reflect FSA's advice.[3] The FSA may also issue guidelines or set prudential guidelines in circular letters, but these do not have the same legal status as laws and regulations.

**17. The FSA has supervisory powers to limit banks' unsound practices and excessive risk-taking behavior.** The Financial Institutions Act (section 14–6) gives the FSA the power to issue supervisory measures against institutions (including banks and holding companies of financial groups) that do or are likely to fall short of minimum prudential requirements or buffers. These measures include: changing the organization, management, and control of the business and strategies; holding capital in excess of minimum requirements; reduce the risks of the business or change it; reduce asset liability mismatches; curb the scope of performance-related remuneration; and limit dividend payouts. The Financial Supervision Act (Section 4) also empowers the FSA to order supervised entities to: arrange audits or internal control in accordance with the rules set by the FSA, restrict credit to a customer to a lower amount than the statutory minimum, alter the composition of the control committee, rectify matters where an institution's bodies fail to discharge their duties according to the law, and rectify any inappropriate investment of the institution's funds.

**18. However, important supervisory powers and decisions are kept to the MoF or can be overturned by the MoF.** All FSA supervisory decisions and measures can be subject to review by the MoF. If a supervised entity disagrees with the decision of the FSA, they can complain or appeal to the MoF, which can rule in favor or against the decision of the FSA. Over the last five years, 13 bank-related FSA decisions were appealed to the MoF. These cases include review of pillar 2 requirements, changes to requirements on IRB models, exemptions from prudential requirements, and review of licensing decisions. The MoF has accepted two appeals where it ruled against the

[3] One example is the MoF's decision to reject an FSA proposal to increase the number of domestic systemically important banks (DSIBs) based on regional criteria (see Box 1 for more details). Another is the MoF's decision to reject adopting the FSA's 2018 proposed changes to residential mortgage lending requirements (see Box 3 for details).

FSA's decisions. Many other appeals are still pending, and some take a long time to be reviewed due to the technical nature of the decision appealed. Such a setup risks subjecting the appeals process to nontechnical considerations which may hamper the effectiveness of the supervisory oversight function. Therefore, consideration should be made to ensure that appeals are decided by specialized independent bodies.[4]

**19. While applications for a banking license shall be reviewed by the FSA, the MoF has the ultimate power to decide on granting a license.** In practice, the MoF decides on applications of major importance or in cases likely to set a precedent and the FSA makes recommendations on these applications.[5] The FSA decides on other cases under powers delegated to it by the MoF. The power to revoke a banking license is also given to the MoF under the Financial Institutions Act (Section 3–7). Those powers are delegated to the FSA for licensing powers that are also delegated by the MoF to the FSA. While the MoF is also responsible for deciding on significant changes in banks' ownership (qualifying holdings), these powers are delegated to the FSA, except for cases of significance and/or where a principal character is involved as well as decisions for institutions of material importance. Acquisitions of a qualifying holding in a financial institution in non-EEA countries require also authorization by the MoF.

## B. Supervisory Independence

**20. The FSA is governed by a non-executive board and managed by a director general. According to the Financial Supervision Act, the FSA board is appointed by the MoF for a period of four years.** It consists of five persons plus two alternates plus two staff members. Norges Bank has an observer on the board. The Director General is appointed by the King in Council (Cabinet) for terms of six years. The provisions of the Financial Supervision Act do not mention the cases and conditions for the dismissal of FSA Board members and Director General. But the Civil Servant Act which also applies to the appointment and dismissal of the director general (and FSA staff) stipulates (under Section 15) that dismissal takes place in cases of gross negligence or improper behavior. However, there is no obligation to publicly disclose the reason of removal from office, as is required under Basel Core Principles for effective banking supervision (BCP 2–EC2).

**21. There are several areas where the FSA's operational independence may be compromised or influenced by the MoF.** The MoF has the power to: set annual goals to the FSA and issue instructions to the FSA; review and reverse the FSA's supervisory decisions and actions (see above); and to set and define the FSA's budget and total resources. The authorities stressed that the MoF's competence in this area is based on well-established, well-founded, and well-functioning national constitutional principles, which govern relationships between the legislative and the executive branch of government and between various parts of the executive branch. While noting that these issues generally emanate from Norway's Constitution and apply to all state

[4] For more examples about practices on appeals processes related to supervisory decisions, please refer to a 2009 IMF working paper on Governance Practices at Financial Regulatory and Supervisory Agencies.

[5] These include mainly cases with qualifying shareholders or cases of mergers among banks and financial institutions.

agencies, they could compromise FSA's operational independence and its ability to adequately fulfill its mandate.

**22. The MoF sets goals and priorities for the FSA which may not always align with the FSA's priorities or available resources.** In line with the system of public administration, the MoF issues an annual letter of allocation to the FSA as well as additional tasks throughout the year. The letter of allocation sets the FSA's budget, goals, and priorities for the upcoming year. The letter is drafted with input from the FSA and forms the basis of the FSA's annual workplan. While the goals and priorities set in the letter of allocation are usually discussed between the MoF and the FSA, they represent the MoF's priorities and goals which often, but not always, concur with the FSA's goals and priorities. The additional tasks and assignments are in the form of requests for studies and analysis in various areas, drafting of legislation, and reports on various operational issues. One example where priorities might differ is the regulatory sandbox that is currently being established by the FSA in line with the expectations of the MoF.

**23. Besides having the power to reverse the FSA's supervisory decisions, the MoF can issue instructions to direct the FSA on dealing with prudential and operational supervisory issues.** The MoF may instruct the FSA to follow-up on institutions in another manner than intended by the FSA. There have been a couple of examples of such instructions over the last few years. One example is a letter issued by the MoF in 2016 expressing clear views on how the FSA should handle pillar 2 requirements in the course of its supervisory review process. This letter requested the FSA to work on making the calculation models and methods in Pillar 2 capital requirements more predictable and transparent. Another example is related to insurance where the FSA decided to reduce the maximum interest rate of technical provisions in life insurance but the MoF instructed the FSA later not to reduce that rate. In addition, the FSA may at its own initiative suggest amendments to laws and regulations, which the MoF chooses not to follow up or act upon (see previous section for further details and examples).

**24. The FSA is subject to a transparent and thorough accountability framework.** The FSA reports to the MoF and the Parliament through published annual reports. The annual report gives a thorough overview of the performance and operations of the FSA and its resource spending. In addition, some confidential issues are covered in separate annual and ad hoc reports. The FSA also prepares four-year strategic plans which set out the main objectives and immediate goals. Then, each year, the FSA prepares a plan of operations setting out measures and tasks to support each operational goal in the strategy. Consequently, the FSA provides the MoF a separate report on its performance and achievements within each of the operational goals set in the strategy. The FSA also provides the MoF other regular and ad hoc reports in a number of areas.

## C. Supervisory Resources and Budgeting

**25. The budget of the FSA is subject to the direct control of the MoF.** The FSA prepares a budget proposal for each year based on its own assessment of required supervisory resourcing and staffing. The MoF decides on the budget and sets limit to FSA's total resources as part of the

government budget, subject to parliamentary approval. The budget is covered in full by levies from the supervised entities in accordance with Section 9 of the Financial Supervision Act.[6] The budget is granted under the condition to be used in accordance with the goals and priorities given in the government budget and the letter of allocation. The FSA can present proposals to the MoF to allocate funds to new areas to cover increases in expenditures beyond the FSA control. These changes are usually submitted by the MoF to the Parliament for approval. While the FSA periodically takes stock of existing skills and projected requirements,[7] it may be useful for the FSA to look into additional ways to better support its additional resource needs, such as external benchmarking exercises and independent resource evaluation.

**26. Over the last few years, the letters of allocation from the Ministry point out to some constraints over FSA budget and expense allocation.** The letters of allocations mention repeatedly that the FSA is expected to operate under tighter budgets going forward and that the reform on reducing bureaucracy and creating efficiencies (such as more reliance on automated and IT tools) will be included as an integral part of the budgetary procedures. The letters of allocation also mention that expenses exceeding the FSA's operating budget must be authorized by the MoF and must be offset by savings over the next five years. In addition, the management of some budget line items requires authorization by the MoF. While some of these budget authorizations are delegated on a yearly basis to the FSA, others remain with the ministry. These authorizations further limit the autonomy of the FSA over its own budget and reduce its ability to flexibly manage that budget.[8]

**Table 2. Norway: Evolution of FSA Staffing Resources**

| Area | 2016 | 2017 | 2018 | Average Annual Change (percent) |
|---|---|---|---|---|
| Number of Permanent Staff | 270 | 276 | 302 | 5.9 |
| Actual overall FTE | 253.5 | 251 | 254 | 0.1 |
| Actual FTE - Overall Banking Supervision | 57.9 | 58.1 | 58.4 | 0.5 |
| Of which: | | | | |
| - Bank Supervision | 19.7 | 18.5 | 18.5 | - 3.1 |
| - Licensing and crisis management | 5.4 | 6.3 | 8.1 | 24.3 |
| - Solvency / models | 8.2 | 8.6 | 7.3 | -5.2 |
| - Data and Analysis | 9.8 | 10.2 | 8.7 | -5.4 |
| - Macroeconomic Surveillance | 6.7 | 7.6 | 8.7 | 15.3 |

Source: FSA.

[6] The FSA stipulates for each year the minimum and maximum amount that can be allocated to each individual institution within each category of supervised entities. The allocation is carried out by the FSA after the proposal has been sent to the industry associations for comments.

[7] In preparing its strategy plan for 2019–22, the FSA carried out an evaluation of its existing and needed skills over that period, taking into account emerging supervisory practices and expected retirements. Gaps in skill-sets were also identified.

[8] According to the 2019 letter of allocation, budget authorization is delegated to the FSA when it comes to the need to enter into agreements to purchase services within the year's appropriations. However, the lease for office premises is not delegated to the FSA. Budget authorization is also required by the MoF for the transfer of unused appropriations from one year to the other and the reallocation of funds from operating expenses to major equipment purchases and maintenance.

**27. The budgetary controls set by the MoF and the government could have adverse implications on the ability of the FSA to get needed resources.** The FSA budget has been steadily increasing over the last five years, including for banking supervision activities, to reach 426.3 million NOK in 2019 up from 343.3 million NOK in 2015, i.e., an average annual increase of 4.8 percent. However, the budget proposed by the FSA is subject to cuts, including efficiency cuts, imposed by the MoF and the Government. In addition, the FSA budget was subject to a hiring freeze during 2014–16 which was applied on all public agencies. While the overall staffing resources of the FSA have increased over the last three years, the actual resources spent on banking supervision have remained stable (see Table 2). The FSA has a relatively low turnover rate. However, there has been some recent challenges in recruiting and retaining staff with legal as well as modelling expertise. The FSA is also facing some difficulties in retaining high-performing young employees with 3–5 years of experience. The authorities indicated that the case for more resources may be made within every aspect of government activity and cannot be assessed independently of the total budget. They further noted that the existing budget procedures have been developed to enable the Storting to establish sound general spending levels and to prioritize resource allocation across all sectors, based on a comprehensive proposal from the government.

### Recommendations

**28. While noting the constitutional issues involved in the institutional framework of the FSA, the authorities are encouraged to address the challenges that the current setup poses to FSA's powers and independence.** These challenges may limit the ability of the FSA to conduct effective supervision. They also mean that regulatory standards and supervisory decisions and measures may not be taken on purely financial stability grounds but also based on other non-technical considerations. Therefore, the authorities are encouraged to explore various options to strengthen the powers of the FSA, improve its operational independence, and increase its budgetary autonomy, while ensuring that the FSA remains subject to a thorough, robust, and transparent accountability mechanism[9] In this regard, it is recommended to:

- Grant the FSA the power to make prudential regulations, particularly in relation to micro-prudential supervisory issues.
- Make the FSA responsible for deciding on all applications for bank licenses, transfer of significant ownership in banks, and major acquisitions as well as for deciding on the revocation of bank licenses.
- Limit the powers of the MoF to issue instructions to the FSA and decide on appeals to the FSA supervisory decisions and measures.

[9] For more details on international practices on supervisory accountability, please refer to the 2015 report by the Basel Committee on Banking Supervision on the impact and accountability of banking supervision.

- Give the FSA more autonomy in determining and managing its budgetary resources and ensure that it is given the needed resources to effectively carry out its mandate.

- Enact legislative changes that would require the public disclosure of the reasons for the removal from office of the FSA board members and director general.

# SUPERVISORY APPROACH AND CORRECTIVE ACTIONS

## A. Supervisory Approach and Processes

**29. The FSA adopts a risk-based approach to supervision.** The FSA risk assessment methodology is based on the European Banking Authority (EBA) guidelines on common procedures and methodologies for Supervisory Review and Evaluation Process (SREP). To that end, the FSA divides banks into four categories based on size, complexity, business model and the degree of risk the institution poses to the financial system. The actual categorization of the entities corresponds first and foremost to the size and the complexity of the institutions. The classification determines to large degree the scope and frequency of the FSA's offsite and onsite activities for each type of firm. Box 1 provides more details on the categorization criteria of firms and the implications for their onsite activities.

### Box 1. Categorization of Banks and Implications for Supervisory Activities

The FSA divides banks into four categories for the purpose of the detailed SREP and the conduct of offsite and onsite supervisory activities. The main categorization criteria depend on size, complexity and business model but other risk factors are also considered. Below are the categories and the classification criteria:

- Category 1: Comprises institutions which the MoF designates as Domestic Systemically Important Banks (DSIBs) based on two criteria: the bank has total assets equivalent to at least ten percent of Norway's GDP or it has a share of five percent of the Norwegian lending market.[1] Currently, there are two DSIBs, DNB and Kommunalbanken. Before the conversion of Nordea to a branch in 2017, it also used to be a DSIB. This category also includes the Norwegian subsidiaries of foreign banks since the FSA is required to conduct an annual SREP for discussion in their supervisory colleges.

- Category 2: Comprises large and medium-sized institutions mainly operating in the domestic market. These institutions have high market shares nationally or regionally or could impose high risk to the deposit guarantee fund due to high shares of guaranteed deposits. The majority of these banks operate across several lines of business, including offering loan facilities and other financial products to the retail and corporate markets. Currently this category consists of 13 banks.

- Category 3: Comprises small and medium-sized institutions operating in a limited number of lines of business, mainly in a local geographical area of Norway. They have a limited product range and mainly offer loans to the retail market and small and medium-sized local entities. This category comprises other Norwegian institutions (beyond those in category 1 and 2) with total assets exceeding NOK 5 billion.

**Box 1. Categorization of Banks and Implications for Supervisory Activities (concluded)**

- Category 4: Comprises small institutions operating in a local geographical area of Norway. They have a limited product range and offer mainly loans to the retail market and small and medium-sized local firms. This category comprises Norwegian institutions with total assets under NOK 5 billion.

The frequency, scope and breadth of the FSA's work for each category of firms is shown in the table below.

| Category | Risk Monitoring | Detailed SREP | Simplified SREP review | Scope of contact with the institution |
|---|---|---|---|---|
| 1 | Quarterly | Annually | Annually | Regular contact with Board of Directors (BOD) and management. |
| 2 | Quarterly | Every second year | Annually | Regular contact with BOD and management. |
| 3 | Quarterly | Every third year | Annually | Contact with BOD and management when called for based on risk, at least every third year. |
| 4 | Quarterly | Depending on risk assessment[2] | Annually | Contact with BOD and management when called for based on risk assessment. |

Source: FSA.

[1] In November 2018, the FSA proposed to add a third regional criterion which would have resulted in six more DSIBs but the MoF did not agree to that change.

[2] For these banks, there is no frequency for the detailed SREP assessment, but the FSA will decide annually whether such an assessment is needed depending on whether the capital adequacy of the bank is significantly higher than the minimum pillar 1 requirements and capital buffers. This is currently interpreted as having a capital adequacy ratio that is at least six percentage points above the minimum requirements (including buffers), i.e., more than 18 percent.

**30. Offsite supervisory activities focus on a number of risk indicators and tools.** The FSA monitors macroeconomic trends and financial market developments and also follows individual institutions on an ongoing basis. Selected risk indicators and key financial figures are monitored based on quarterly reported data and other market information. In addition, an analysis of the risk of the banks' corporate lending portfolio is performed using the SEBRA analysis model. A simplified SREP review is performed annually for all banks, covering capital, liquidity, market risk, operational risk, governance and internal controls. The FSA is also considering now a more comprehensive early warning system based on selected parameters, basically relying on indicators of capital, assets, earnings, liquidity in addition to the use of SEBRA data (CAELs).

**31. Supervisory activities focus mostly on the largest and most complex banking groups (categories 1 and 2) although some medium and small banks are also prioritized.** For the largest banking groups, the simplified SREP review (SRV) has a broader scope and in-depth assessment than the more simplified and general annual risk analysis (mini-SRV) conducted for small entities. These activities are important inputs in setting onsite inspection plans and priorities and in

preparing detailed SREP reviews which include a written feedback and capital decisions (Pillar 2).[10] The frequency of the detailed SREP review differs according to the various categories of institutions (see Box 1). However, there is no comprehensive risk scoring for all institutions which can serve as a tool to prioritize supervisory activities not only based on systemic impact but also on risks. The SREP score is only produced for a number of institutions (that are subject to a detailed SREP review).

**32. The various SREP reviews and quarterly monitoring exercises form a basis for planning and performing supervisory activities.** A sector-wide annual plan of activities is prepared towards the end of each year that includes, among others, the list of banks that should be inspected onsite, SREP reviews, recovery plan assessments, and topics for thematic reviews. An annual supervisory plan is also developed for each bank. The FSA has developed risk modules for each of the main risk types—credit risk, market risk, liquidity risk, operational risk, and internal governance. These set out thorough internal guidance for FSA supervisors and serve as a tool to set the supervisory expectations for banks. In addition, the FSA occasionally conducts off-site surveys to assess certain risk areas, the institutions' compliance with selected regulations, or the need to perform certain thematic inspections. Some examples of surveys that resulted in thematic onsite inspections include CRE exposures and IFRS 9 implementation.

**33. FSA's onsite supervisory activities are also focused on larger banks.** The annual supervisory plan for the largest banks typically includes multiple targeted on-site inspections, an annual risk assessment, and SREP. Onsite inspections are usually performed as general inspections, targeted inspections, thematic reviews, or inspections focusing on information and communication technology (ICT) or on internal ratings-based (IRB) models. For larger banks (categories 1 and 2), a number of targeted onsite inspections are usually performed focusing on few risk categories whereas, for smaller banks, a general full-scale inspection is conducted covering around 6–10 banks each year. The selection of small banks is based on a number of financial indicators as well as on credit and liquidity risks. Thematic reviews are also performed each year for different topics selected based on market development and financial stability risks.[11] The FSA interacts with bank management but much more regularly for large banks and less so for smaller banks.

**34. The extent of onsite supervisory activities has been generally decreasing and remains at a very low frequency for small banks.** Table 3 shows that the number of onsite inspections over the period 2016–18 has witnessed a downward trend. In addition, a large number of the performed inspections was focused on IRB models and ICT, leaving the number of inspections over other risks (such as general credit risk, liquidity risk, governance) low. This is at least in part due to the limited resources of the FSA. In addition, the frequency of inspections over small banks (particularly

[10] The SREP assessment and findings as well as the preliminary pillar 2 requirement are communicated in a letter to the bank's board of directors. Following interaction, a final pillar 2 assessment is made, a summary of which is published on the FSA website.

[11] Some of the thematic reviews performed over the last couple of years covered governance/ risk management, operational risk, commercial real estate exposures, consumer lending, and IFRS 9.

category 4 banks) remains very low. In fact, a number of small banks has not had an onsite inspection for 7–10 years.

**Table 3. Norway: Types and Frequency of Onsite Inspections**

| Type of Onsite Inspection | 2016 | 2017 | 2018 |
|---|---|---|---|
| General | 14 | 9 | 3 |
| Targeted | 11 | 7 | 8 |
| Thematic | 7 | 5 | 6 |
| AML (only) | 1 | 0 | 4 |
| Other (IRB, ICT) | 19 | 17 | 15 |
| **Total** | **52** | **38** | **36** |
| *Of Which:* | | | |
| • *Category 1* | *7* | *8* | *6* |
| • *Category 2* | *26* | *11* | *12* |
| • *Category 3* | *10* | *14* | *8* |
| • *Category 4* | *6* | *1* | *5* |
| • *Foreign banks / branches* | *3* | *4* | *5* |

Source: FSA.

**35. The FSA supervisory activities over branches of foreign banks, even those with significant or systemic presence, are limited and primarily rely on home supervisors.** Foreign bank branches account for more than 35 percent of Norway's banking system assets. One of the branches is the second largest bank in Norway, and three branches overall are systemic or significant relative to the banking system in Norway. The Norwegian prudential legislation is not fully applicable to foreign branches operating in Norway,[12] so the supervisory approach towards branches is mainly limited to conduct and compliance issues, especially when it comes to onsite inspections. The FSA also performs annual risk assessments of foreign bank branches that are included in the group's overall risk assessment by the home supervisor, as part of the annual joint risk assessment process and the joint decisions on capital, liquidity and funding. In addition, there is limited financial information reported by foreign bank branches to the FSA.

**36. Memoranda of Understanding (MoUs) signed with foreign supervisors allow exchange of information and coordination for the supervision of foreign bank branches and subsidiaries.** The FSA has entered in supervisory college agreements with relevant supervisory authorities of foreign banks' branches and subsidiaries. In addition, Norway is a signatory to the MoU of the Nordic Baltic Stability Group on cross border financial stability and also the Nordic MoU on supervision of significant branches with supervisory authorities in the Nordic countries and the European Central Bank (ECB). This latter MoU calls for intensification of collaboration between the

[12] Foreign banks operating in Norway through branches must follow some applicable national legislation, such as the Money Laundering Act, the regulatory requirements on residential mortgage lending and those on unsecured consumer lending.

host and the home member states for large branches considered systemically important in the countries they operate. It recognizes that the main responsibility for the supervision of significant branches rests with home supervisors but emphasizes the need for this supervisor to consider concerns raised by host authorities.

**37. While the existing supervisory activities and the supervisory coordination with the home authorities of systemic foreign bank branches is welcome, the direct involvement of the FSA in supervising these branches could be further expanded.** Those branches represent a significant risk to financial stability, particularly in stress conditions, and are generally covered by Norway's financial safety net arrangements. The FSA should therefore increase its monitoring of those systemic branches and its supervisory oversight of their activities, including through onsite supervision. This is particularly relevant for systemic branches where the activities of the home supervisor over the branch may not address adequately the systemic relevance of the branches from Norway's perspective.

**38. While the FSA started assessing banks' recovery plans, the preparation of bank resolution plans is still work in progress.** Section 20 of the Financial Institutions Act, which became effective in January 2019, requires banks to have recovery plans[13] and requires the FSA to prepare a resolution plan for each institution. The FSA had previously requested the large banks to prepare recovery plans before the entry of the law into effect. It has also published guidelines on recovery planning in June 2019. Banks' recovery plans are typically assessed on a periodic basis depending on the SREP category of the institution[14] and are also evaluated during onsite inspections. If the FSA deems the plan insufficient, it may require the institution to make changes. In 2019, the FSA has thus far assessed the recovery plans of several mostly large institutions and has provided written feedback in a number of cases. As to resolution plans, the FSA has so far prepared a draft resolution plan only for the largest DSIB and presented it to the supervisory college in September. The FSA plans to proceed with developing resolution plans for other systemically important and large institutions as a priority.

**39. While the FSA has thorough supervisory processes and procedures, it does not have a quality assurance or an internal audit function to periodically check and enhance the effectiveness of its available supervisory tools**. The FSA is a member of the three European supervisory authorities EBA, ESMA, and EIOPA. These authorities administer independent reviews amongst European national supervisory authorities, in which the FSA participates. The peer reviews give an overview of the effectiveness of the framework at EU/EEA-EFTA authorities for some particular themes and their alignment with the EBA technical standards and guidelines. The FSA is also subject to reviews by the office of the Auditor General (which undertakes mostly annual internal audits of the FSA accounts) or by the MoF based on self-assessment reports from the FSA or third-

[13] All banks are required to have recovery plans starting January 2019 except banks with total assets below NOK 5 billion which are required to have a recovery plan from January 2020.

[14] Banks recovery plans are assessed with written feedback to the institution, with the following frequency: annually for SREP category 1 institutions, every other year for SREP category 2 institutions, and at least every third year for SREP category 3 and 4 institutions.

party reviews. While these reviews are useful, the FSA may want to consider establishing a quality assurance function that performs a more comprehensive assessment of the FSA processes with a view to improve practices and address any findings or gaps.

**Recommendations**

**40. While the FSA supervisory approach is generally sound and its supervisory process is thorough, there is scope for further improvement.** Specifically, the FSA is recommended to:

- Further take into account the risk profile of banks in planning and performing its supervisory activities by ensuring that:
  - Medium and small banks with relatively high-risk profiles are subject to increased scrutiny, particularly in regard to onsite inspection.
  - The intensity of the supervisory activities related to large banks take into account the differences in the risk profiles of these banks.
- Strengthen monitoring and host supervision of systemic foreign bank branches given their impact on financial stability.
- Continue the work on reviewing banks' recovery plans and drafting resolution plans, particularly for systemic and large banks.
- Consider establishing a quality assurance or internal audit function to oversee the quality and consistency of its supervisory approach and continuously improve its supervisory procedures and processes.

**41. While the above recommendations may be partially implemented by reprioritizing the FSA current resources, their effective implementation would also require additional resources.** Therefore, granting further budget autonomy to the FSA, as recommended in the previous section, would better allow it to manage its budget based on its resource needs and effectively increase the breadth of its supervisory activities.

## B. Corrective Action Framework and Processes

**42. The legal framework provides the FSA with a broad range of tools and powers to address banks' problems and weaknesses but the conditions to apply some of these tools could be broadened.** The Financial Supervision Act provides the FSA powers to, inter alia, require banks to enact changes in internal controls, maintain a higher capital ratio than the minimum requirement, reduce credit risk to particular customers, rectify matters due to the failure of the institution's bodies in discharging their duties, or correct any inappropriate bank investments or activities. The Financial Institutions Act also provides the FSA with powers to require banks to change their organization and management, curtail or change their business and reduce their risks, change their remuneration policies, and limit dividend payout policies. However, the conditions to

apply the powers and measures listed in the Financial Institutions Act seem linked mostly to cases where the bank falls below capital requirements. It is not clear to which extent these powers can be applied for weaknesses or unsound practices that may not have resulted in a breach to minimum capital requirements.

**43. The Financial Institutions Act also provides the FSA with a wide array of early intervention tools but some of these tools require coordination with the MoF or its approval.** The Act requires an institution to notify the FSA in case of actual or likely infringements to the requirements in the near future. In this case, the FSA is given a range of tools which application depends on the severity of the bank's situation and its implications for financial stability. These tools include, inter alia, initiating measures in the recovery plan, drawing up an action plan to restore the institution's position, drawing up plans for negotiating the restructuring of the institution's debt. If there is a significant deterioration in the institution's financial situation, or serious infringement of legal requirements or serious administrative irregularities, and other available measures are considered insufficient to rectify the situation, the FSA may require changes to be made to the composition of the board of directors or senior management. If this is also considered insufficient, the FSA may appoint a temporary administrator. The FSA may—after approval by the MoF—adopt a decision to write down or convert own funds. If this also proves insufficient, the MoF may adopt resolution or winding up proceedings according to sections 20-15 and 20-29 of the Act.

**44. However, the FSA's corrective action and sanctioning powers are limited in some respects.** As mentioned earlier, the FSA does not have the power to revoke bank licenses except where this power has been delegated to it by the MoF. As also mentioned earlier, all supervisory decisions and corrective measures of the FSA can be appealed in front of the MoF. The FSA also has very limited sanctioning powers. The laws do not provide the FSA with the power to apply fines except in the case of breaches to the AML act. A daily fine can be applied by the MoF (power currently delegated to the FSA) during the period in which the bank is in breach of laws and regulations, but the amount is normally limited and cannot be imposed once a bank has rectified the situation.

**45. The FSA prefers to address banks' problems through moral suasion and rarely resorts to the use of formal corrective actions.** The FSA points out to gaps in its inspection reports and expects banks to take corrective measures to address the findings of its offsite and onsite supervisory activities. However, a review of the FSA supervisory files, particularly inspection reports, does not suggest that the FSA is assertive enough in its requests for corrective measures by banks. The FSA is of the position that moral suasion can be a more effective tool in addressing bank weaknesses and to make banks implement the supervisory recommendations. In addition, the FSA considers that the banks understand the FSA expectations and act accordingly. It also considers that the publication of inspection reports creates a pressure on the banks to address and rectify the problems. While this can be an effective approach in some cases, there is a need to continuously assess the evolution of banks' problems and weaknesses and whether there is undue reliance on moral suasion that may cause a delay in taking corrective actions in a timely and appropriate

manner. A review of some banks' cases suggest that the FSA can be more proactive in its corrective action approach for banks with weaknesses and problems.

**Recommendations**

**46. The legal framework provides a reasonable range of corrective powers to the FSA, but some gaps still exist as well as some limits on the scope and use of these powers.** Therefore, it is recommended to review the legal framework, with a view to enabling the FSA to:

- Apply significant fines and sanctions in case of banks' breaches of legal and prudential requirements.
- Take some corrective actions and measures directly, such as withdrawing bank licenses, or taking some intervention measures (such as writing down or converting own funds) without the need to get MoF approval.

**47. The FSA should take more active approach in using its corrective powers in case banks' weaknesses and problems persist.** In such cases, its approach that relies on moral suasion may result in delays to resolve these issues.

# PRUDENTIAL REGULATIONS AND FRAMEWORK

## A. Capital Adequacy

**48. The Norwegian banking system is currently well-capitalized.** Banks' capital adequacy has improved steadily since 2008 (i.e., since the global financial crisis) owing to consistent and sustainable profitability; strong asset quality; and retention of earnings. The Common Equity Tier 1 (CET1) ratio was 16.1 percent (end-March 2019) compared to 13.0 percent at end-December 2014 and 7.3 percent at year-end 2008. The end-March 2019 systemwide leverage ratio was 7.6 percent, virtually unchanged from a year earlier. All Norwegian banks met the risk-based capital and leverage ratio minimum requirements at the end of Q1–2019.

**49. At the present time, the Norwegian regulatory capital framework is consistent with the minimum Basel III global standards.** Pillar 1 Minimum regulatory capital requirements for CET1, Additional Tier 1 (AT1), and Tier 2 risk-based capital ratios, as well as the non-risk-based leverage ratio, are in line with the global minimum Pillar 1 standards as established by the Basel Committee on Banking Supervision (BCBS).

**50. The current regulatory framework is likewise consistent with and in some ways exceeds Basel III's capital buffers.** Norwegian regulations require all banks to maintain a Capital Conservation buffer of 2.5 percent and a Countercyclical Capital Buffer (CCyB), which was set at 2 percent at the time of the mission and was increased to 2.5 percent at end-2019. These buffers are comprised of CET1 capital as called for by Basel III. In addition to the global minimum leverage ratio of 3 percent, Norwegian banks are subject to a 2-percentage point leverage ratio buffer for a total

leverage ratio requirement of 5 percent. Financial institutions identified as domestic systemically important banks (D-SIBs) are required to maintain this level plus an additional leverage ratio buffer requirement of one percentage point. Moreover, in recognition of Norway's less diversified economy, relatively strong cyclical fluctuations and high household debt levels, the authorities require all banks to maintain a Systemic Risk Buffer (SRB). While not specifically defined in the Basel III framework, an SRB-like feature is consistent with Basel III, which notes that jurisdictions may elect to implement more conservative requirements and/or accelerated transitional arrangements as is necessary in the jurisdictional context. See Box 2 for more details on banks' regulatory capital requirements.

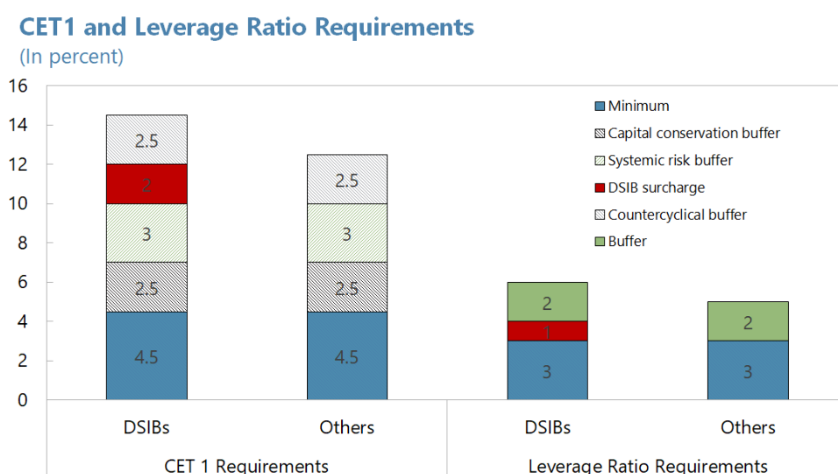
**51. Adopting the EU framework and relinquishing the ability to adopt more rigorous standards represent a weakening of existing requirements.** As the basis for its regulatory capital framework, Norway, as a signatory to the EEA agreement, has elected to adopt the EU's regulatory capital framework.[15] Adoption of the EU framework will weaken existing standards and will preclude Norwegian authorities from adopting more rigorous standards. It will also require Norway to relinquish certain prudential capital measures currently in place that do not align with the EU framework. The EU framework, as set out in the EU's Capital Requirements Directive (CRD IV) and Capital Requirements Regulation (CRR), transposes the global Basel III framework into EU law. Once adopted by Norway, financial institutions will be required to adhere to all CRD IV/ CRR Pillar 1 risk-based capital and leverage ratio measures and specificities. This includes certain provisions that deviate and fall below the global minimum standards set out by the BCBS. An example is the small- and medium-sized enterprise (SME) supporting factor, which provides for a reduced risk weight for exposures to SMEs. Since CRD IV/ CRR are subject to maximum harmonization, Norway will be restricted from adopting standards that exceed (i.e. are more rigorous than) the terms set out in the EU framework and will be required to relinquish certain prudential measures currently in place that depart from CRD IV/CRR. This includes notably the Basel I "output floor".

**52. A comprehensive assessment of the impact of the adoption of the EU framework is needed.** Norway's FSA estimates that the removal of Basel I floor and the introduction of the SME factor will lower risk-weighted assets (without a commensurate decrease in riskiness) resulting in an increase in the CET1 ratio by 1.3 percentage points (based on year-end 2018 data). However, there are many other discretions and areas under the EU framework that may, at least collectively, result in additional impact on banks' capital adequacy. But the FSA has not performed such a comprehensive assessment of the adoption of the EU framework.

[15] The EU's capital requirements directive and regulation were incorporated into the European Economic Area (EEA) Agreement on March 29, 2019 and will be transposed into Norwegian law when the EEA EFTA states—Iceland, Liechtenstein and Norway—have lifted their constitutional reservations. Liechtenstein and Norway have already agreed to adopt the EU framework, and Iceland is expected to do so shortly. CRD IV and CRR will enter into effect in each of these jurisdictions soon after Iceland formally approves the framework.

## Box 2. Capital Requirements in Norway: Current Situation and Planned Changes

Banks are subject to a set of minimum capital requirements and buffers. The minimum requirements and the capital conservation buffer are set in accordance with international requirements. The SRB level is justified by a less diversified economy, relatively strong cyclical fluctuations and high household debt levels. The SRB and the DSIB buffer are cumulative and apply to all exposures. The countercyclical buffer was set at 2 percent in October 2019 but was increased to 2.5 percent at end-2019. Furthermore, all banks must meet a minimum leverage ratio requirement of 3 percent, as well as a leverage ratio buffer of 2 percent. DSIBs must meet an additional leverage buffer requirement of 1 percent.




There are some expected changes to the capital framework. The EU CRR/CRD IV framework is being transposed into the EEA agreement and expected to enter into force in beginning 2020. As a result of this new framework, the SME supporting factor will be introduced and the currently applied Basel I floor for IRB banks will be removed. These two changes will lead to an increase in regulatory capital ratios of around 1.3 percentage points without a commensurate reduction in risk.

The authorities are of the view that the adaptations of the capital framework to EU requirements should not lead to a general weakening of Norwegian banks' capitalization. Therefore, the FSA is exploring further ways to strengthen the requirements for IRB models and Pillar 2 to reduce the impact of the new weaker requirement. To further address unwanted capital relief, The MoF has also proposed increasing the SRB by 1.5 percent for all institutions (applied only on domestic exposures compared with the current SRB of 3 percent which applies to all exposures), as well as introducing risk weight floors of 20 percent for residential mortgage exposures and 35 percent for CRE exposures. These proposals were issued for consultation until September 2019 and work was underway by the MoF to review the responses and issue the final requirements.

Source: FSA.

**53. To counteract this weakening in requirements, the MoF has circulated for comment a proposal for possible adjustments to the Norwegian capital requirements.** These measures include an increase in the SRB requirement and the introduction of a risk weight floor for real estate loans. However, it is not clear to what extent these measures would effectively counteract the reduction in capital requirements resulting from the adoption of the EU framework.

**54. To compensate for its relatively more limited room for maneuver under Pillar 1, he FSA places substantial reliance on its ability to employ Pillar 2 capital adequacy measures.** The FSA has issued thorough guidance (circular 12/2016) describing its approach to pillar 2 in assessing banks' capital and liquidity needs. This circular has been recently updated to include additional elements that detail the computation of various Pillar 2 components. The Pillar 2 approach includes a mix of prescriptive and principles-based requirements. The prescriptive requirements apply mainly in relation to concentration risks where the FSA uses benchmarks based on the Herfindahl Hirschman index (HHI) to compute capital charges for single name and sectoral concentration. For other risks and areas, the FSA has described the main criteria it looks at when assessing banks' Pillar 2 capital add-ons.

**55. The FSA should continue to thoroughly explain and communicate its Pillar 2 approach and decisions to banks.** The FSA Pillar 2 approach seems sound and relies on a mix of models-based elements and supervisory judgment. In addition, the FSA subjects its Pillar 2 assessments to peer reviews to ensure the consistency of its approach. These are good elements and the FSA should continue to refine its approach further. The FSA should continue its thorough dialogue with banks about the Internal Capital Assessment Adequacy Process (ICAAP) to ensure that banks understand well the considerations made in the FSA approach to Pillar 2 and the reasons for the differences between banks' own ICAAP assessments and Pillar 2 capital requirements.

**Recommendations**

**56. Given the relatively high and robust capital requirements and the thorough Pillar 2 process, only minor refinements are needed to banks' capital needs and requirements.** For that purpose, the authorities should determine and monitor the implications of the transposition of the EU rules on banks' capital and continue their actions to set additional capital requirements to compensate for the reduction in banks' capital requirements.

## B. Credit Risk

**57. Credit risk is the predominant risk exposure among Norwegian banks and real estate exposures represent approximately three-quarters of bank lending.** Supervisory requirements governing credit risk management, internal controls and oversight are applied on a proportionate basis. With the exception of specified guidance on prudential aspects related to loan loss provisioning and the valuation of real estate collateral, the FSA's supervisory guidance is considered thorough.

**58. Prudential guidance on loan loss provisioning and the valuation of real estate collateral is lacking.** Banks in Norway rely on an accounting standard for guidance on estimating loan loss provisions. IFRS 9 is an International Financial Reporting Standard developed by the International Accounting Standards Board that specifies how an entity should treat impaired financial assets. IFRS 9 came into effect on January 1, 2018 for the large Norwegian banks. It will apply to all financial institutions in Norway from January 1, 2020. Similarly, prudential guidance on the valuation of real estate collateral does not exist. Banks rely on the same commonly available model that takes account of recent property sales to estimate the value of the property that is collateral for the bank's mortgage.

### Residential Mortgages

**59. Home ownership in Norway is comparatively high and housing finance represents a substantial portion of overall bank lending and total bank assets.** At 77 percent, home ownership in Norway is relatively high[16] and residential mortgage lending accounts for approximately 54 percent of banks' total lending at end June 2019.[17] Norway's tax policy provides strong incentives for home buying and financing (e.g., these measures relate to income tax deductibility of interest paid on mortgage debt, favorable capital gains tax on the sale of real estate, and reduced wealth tax valuation of real estate holdings). At the same time, however, persistently high household debt and a steady climb in house prices are vulnerabilities cited by the Norges Bank and the FSA.[18]

**60. Losses on residential real estate loans are low.** Loan losses have been stable and consistently low. Total loan losses at end-March 2019 were around 0.1 percent of average total assets. Losses on loans for the corporate lending market and the personal customer market were respectively 0.2 percent and 0.1 percent of total loans at end-2018.[19]

**61. Temporary prudential requirements governing residential real estate lending were adopted in 2015, extended in 2018, and were extended further until end-2020.[20]** The regulations include an affordability test, debt-to-income (DTI) limits, loan-to-value (LTV) limits, and flexibility quotas. For more details on these limits, see Box 3. For banks that use the IRB approach for calculating regulatory capital for credit risk, Norway has adopted a 20 percent floor for the loss-

[16] See Statistics Norway for home ownership statistics. Global data available at www.worldatlas.com/articles/countries-with-the-highest-home-ownership-rates.html.

[17] See Norway FSA's June 2019 Risk Outlook, chart 3.7 for a breakdown of banks' loan portfolios.

[18] See Norges Bank Financial Stability Report 2018 and the FSA's Risk Outlook.

[19] See Norway FSA's June 2019 Risk Outlook, charts 3.2 and 3.A for the breakdown and evolution of loan losses

[20] The prudential regulations governing residential real estate lending were set to expire at end-2019 and were under review by the MoF during the FSAP mission. On November 15, 2019, the MoF decided to maintain these regulations (with some minor changes) until end-2020.

given-default (LGD) parameter for exposures secured by residential real estate. This compares to the global minimum standard of 10 percent for LGDs of exposures secured by residential real estate.

**62. The mortgage regulations appear to have dampened debt growth and house price inflation.** Since the introduction in 2015 and subsequent tightening in 2017, the residential mortgage regulatory reforms have had a direct effect on household borrowing. They have had a dampening effect on debt accumulation in areas where a large share of homebuyers had high debt-to-income ratios. House price inflation in these areas was also restrained.[21]

**63. While more stringent regulations have been necessary and have had the desired effect, they are by themselves insufficient.** In light of relevant macroeconomic vulnerabilities identified by the Norges Bank and the FSA combined with banks' high level of real estate exposures, continued prudent regulatory and supervisory oversight of this risk is warranted. Effective bank supervision is a critical supplement to prudent regulation. The FSA's credit risk modules provide guidance for assessing an institution's credit risk exposure (i.e., quantitative guidance) and its system for managing and controlling credit risk (i.e., more of a qualitative assessment). The guidance is designed primarily for use at large institutions and applied to smaller firms on a proportionate basis based on the bank's size and complexity. While the guidance is generally thorough with respect to residential mortgage lending, it lacks specified guidance on prudential aspects related to loan loss provisioning and the valuation of real estate collateral. These are two essential features of a robust and thorough supervisory program.

## Box 3. Prudential Limits to Address Various Types of Credit Risk

The Norwegian authorities have been taking and are planning a series of measures to curb the risks in various credit areas. These measures mainly target residential real estate lending given the prominence of their share in overall credit activities, but also focus on other sectors, namely unsecured consumer lending and commercial real estate lending. Below are the various measures.

**Borrower-Based Measures**

The authorities have taken a number of borrower-based measures mainly targeted at residential mortgages and recently applied to unsecured consumer lending. The table below shows the main limits applied.

| Measure | Residential Mortgages | | Unsecured Consumer Lending | |
|---|---|---|---|---|
| | Limit | Date | Limit | Date |
| Debt-to-annual income | Less than 5 times | 2017 | Less than 5 times | 2019 |
| Debt servicing capacity | To afford a 5 percent interest rate increase | 2015 | To afford a 5 percent interest rate increase | 2019 |
| Loan-to-value (LTV) | Less than 85 percent (60 percent for second home in Oslo) | 2015 (2017) | | |
| Principal repayments | At least 2.5 percent for loans with LTV > 60 percent | 2016 | Five years maximum | 2019 |
| Flexibility Quota (speed limit) | 10 percent (8 percent for homes in Oslo) | 2017 | 5 percent | 2019 |

[21] See Norges Bank Financial Stability Report 2018.

### Box 3. Prudential Limits to Address Various Types of Credit Risk (Concluded)

- Residential mortgages: Limits on these exposures have been introduced since 2015. An annual mortgage survey is also conducted to capture trends and developments in this sector. As mentioned earlier, the current regulation was extended in June 2018 and set to expire by end-2019, but the MoF extended them further until end-2020. During the latest review of the mortgage regulations at end-2019, the FSA has recommended the adoption of more stringent limits that include (i) a reduction in the DTI limit from 5 times income to 4.5; (ii) a reduction in the flexibility quota from 10 percent (8 percent for Oslo) to 5 percent; and to make the mortgage regulations a permanent feature. However, the MoF decided in November 2019 to keep those limits unchanged until end-2020.
- Unsecured consumer lending: New guidelines for prudent consumer lending practices were adopted in 2017 setting provisions on debt-servicing capacity, maximum debt-to-income ratios, and installment payments. An inspection of some banks' implementation of those guidelines in 2018 showed unsatisfactory outcomes, which resulted in converting these guidelines into binding requirements. The regulation was issued in February 2019 and became effective in May 2019.

**Capital-Related Measures**

- Residential mortgages: in 2014, the FSA issued a circular specifying the calibration requirements for IRB banks' PD and LGD models for residential mortgages. Combined with a portfolio level LGD floor of 20 percent imposed by the MoF, those requirements have contributed to increased average risk weights (above 20 percent, 10-15 percent previously) according to the FSA. A risk weight floor of 20 percent on residential real estate exposures has been proposed as part of the new changes to capital requirements that are being discussed by the MoF.
- CRE lending: according to the Norwegian regulations, exposures secured by commercial real estate are risk-weighted 100 percent in the standardized approach for credit risk. A risk weight floor of 35 percent on CRE exposures has been proposed as part of the new changes to capital requirements that are being discussed by the MoF.

**64. Given the dearth of historical loan loss data, banks using an IRB approach for credit risk may have particular challenges in estimating these risk parameters through the cycle in a robust manner.** Banks using IRB account for approximately 80 percent of assets in the Norwegian banking system, yet IRB banks must use long-term historical loan loss data to help estimate probabilities of default (PD) and LGD for residential mortgages. Availability of such through-the-cycle data is extremely scarce if not nonexistent. For banks that rely heavily on IRB, this data limitation could impair the bank's ability to robustly estimate regulatory capital as well as other functions such as pricing, risk management, or capital allocation. The FSA is well aware of this challenge and in 2014 adopted more stringent IRB parameters in response. These include a minimum PD for mortgage loans of 20 basis points (versus the global PD floor of 3 basis points) and a methodology for estimating LGDs for mortgages that is linked to the exposure's LTV but cannot result in an LGD that is less than 20 percent. The FSA evaluates on an ongoing basis whether stricter IRB requirements are needed.

## Commercial Real Estate

**65. While CRE loan losses have been consistently low, the continued and significant increase in CRE prices is a vulnerability.** CRE represents approximately 14 percent of banks' total lending and accounts for about 40 percent of total domestic lending to corporates. Losses on loans to this segment have been low in recent years—less than 1 percent of total loans—and were virtually nonexistent in 2018. CRE property values have steadily increased (especially in Oslo). This increase, from already high levels, is deemed a vulnerability as prices of commercial property have in the past proven to be more cyclically sensitive than house prices and CRE loan losses have exceeded losses on residential real estate loans.

**66. Norwegian authorities are keenly aware of CRE-related risk and have taken measures to address their concerns.** In 2018 the FSA initiated a comprehensive thematic review and stress test of banks' exposures to CRE. The thematic review, in which eleven Norwegian banks and foreign branches participated, yielded useful data and important insights that were incorporated into various stress tests conducted by the FSA. The review concluded that banks would incur small losses when the price falls are limited to 33 percent (which is in line with what the banks account for in their LTV requirements), but significantly higher losses with higher price declines. The current regulatory capital treatment of CRE requires a risk weight of 100 percent for exposures secured by CRE for banks using the standardized approach for credit risk. This is consistent with the current global regulatory capital framework. The MoF is currently consulting on adjustments to bank regulatory capital requirements for CRE exposures, including a 35 percent minimum portfolio-level risk weight floors for foreign branches operating in Norway.

**67. Concerns about Norwegian banks' exposures to CRE have led to enhanced regulatory measures and heightened supervisory scrutiny but supervisory guidance on this important asset class is lacking.** The FSA's credit risk modules provide supervisory guidance for assessing an institution's credit risk exposures and its system for the management and control of credit risk. Specific guidance is provided on residential mortgage loans and consumer (unsecured) credit but only broad guidance on corporate lending is available with no specified guidance related to CRE exposures.

## Consumer Lending

**68. Annual growth in consumer credit (i.e., unsecured consumer loans and credit cards) remains high (though has slowed somewhat in the past year) while nonperforming loans and loan losses continue to rise.** This asset class represents 3.6 percent of total lending and just under 4 percent of Norwegian household debt. At the same time, consumer loan growth of 10.3 percent (March 31, 2019) far exceeds general credit growth of 5.5 percent while the level of non-performing loans (NPLs) is markedly higher than other loan classes. At end-March 2019, 8 percent of consumer loans were non-performing compared to less than 1 percent for total lending.[22]

[22] See FSA's Risk Outlook, Chapter 3.

**69. The FSA published guidelines on prudent consumer lending practices in June 2017.** As banks' adoption of the guidelines was uneven, in February 2019 the MOF established regulations on requirements for financial institutions' consumer lending practices, which will remain in force until end-December 2020. The new regulations include requirements related to debt service capacity, DTI limits, maturity loan term limits of five years, and flexibility quotas. See box 3 for more details on these requirements.

**70. Given the disproportionate level of losses in the consumer loan category, supervisory guidance needs to supplement the consumer lending requirements.** Accordingly, the FSA's credit risk modules are sufficiently thorough. They provide guidance for assessing an institution's credit risk exposure (i.e., quantitative guidance) and its system for the management and control of credit risk (i.e., more of a qualitative assessment). The guidance is designed primarily for use at large institutions and applied to smaller firms on a proportionate basis based on the bank's size and complexity. As noted earlier, the guidance does not, however, provide specified guidance on prudential aspects related to loan loss provisioning, a credit risk topic of paramount importance and especially for unsecured lending.

**Recommendations**

**71. The FSA should continue its activities to regulate banks' credit risk exposures and oversee their credit risk systems and management.** To that end, the following measures are recommended:

- The FSA should develop specific guidance on (i) prudential aspects related to loan loss provisioning and (ii) the valuation of real estate in line with the relevant Basel guidance[23] and the related EBA guidelines.

- The MoF should at a minimum make key elements of the prevailing mortgage regulations and consumer lending requirements a permanent feature of the Norwegian regulatory framework.

- The FSA should require banks to demonstrate that their IRB data sets for residential real estate loans and for CRE exposures are sufficiently robust and include through-the-cycle data or to justify why existing data sets are adequate; and

- The FSA should develop specified guidance on CRE exposures, and the management and control of credit risk related to CRE exposures similar to the level of granularity provided in its guidance for residential real estate and consumer loans.

## C. Related Party Transactions and Large Exposures

**72. Norway's legal framework (e.g., Financial Institutions Act 2015) that governs related party transactions has been updated to correct previously identified deficiencies, but further**

[23] This includes the 2015 Basel guidance on credit risk and accounting for expected credit risk losses and the 2017 Basel guidelines on the prudential treatment of problem assets.

**improvements are required**. The framework has been updated to include a revised definition of related parties, but the definition still does not include shareholders unless they have controlling interests. Also, the framework now requires transactions with related parties to be in accordance with ordinary business terms between independent parties. It is limited however in that it only covers credit and guarantees to employees and officers.

**73. While regulatory improvements to the related party transactions legal framework have been adopted (and further progress is needed), it is not clear whether sufficient supervisory resources are available to review banks' quarterly reports and to validate their reporting processes.** The FSA has communicated to banks its expectations for managing and treating related party transactions. At the same time, however, it places great reliance on banks' regulatory reporting. It is uncertain as to whether the FSA commits (or has) the necessary resources to review the reports nor is it clear whether it has through the supervisory process rigorously validated banks' reporting processes.

**74. The regulatory framework governing large exposures is consistent with and in some respects exceeds the global minimum requirements.** The large exposures regulation was repealed from December 31, 2019 and replaced by the framework based on the CRR/CRD IV regulation. Authorities have noted that the previous national discretions have been continued in the Norwegian CRR/CRD IV regulation.

**75. To further improve the large exposures framework, the last FSAP recommended that the authorities remove the exception to the 25 percent limit regarding trading book positions, but this weakness still exists.** In general, the FSA expects that banks maintain internal limits that are substantially lower than the limits set out in the regulation. The primary limit on large exposures is 25 percent of a bank's Tier 1 capital, though a few exceptions exist, including 100 percent for interbank exposures of very small banks and a separate treatment for trading book exposures that allows such exposures to go beyond 100 percent if covered by additional capital. These rules on trading book exposures in the Norwegian Large Exposures regulation implements CRR article 395 (5) and 397. Those rules now follow from the CRR, which is implemented in Norwegian legislation through the CRR/CRD IV regulation. Since these provisions do not allow for national discretion, the national provisions cannot be removed.

**Recommendations**

**76. The following measures are recommended:**

- The relevant section of the Financial Institutions Act should be amended so that the definition of related parties is expanded to include all shareholders (regardless of whether they have controlling interests).
- Also, the Financial Institutions Act should be further amended so that it is not limited to just those transactions related to credit exposures and provision of guarantees.

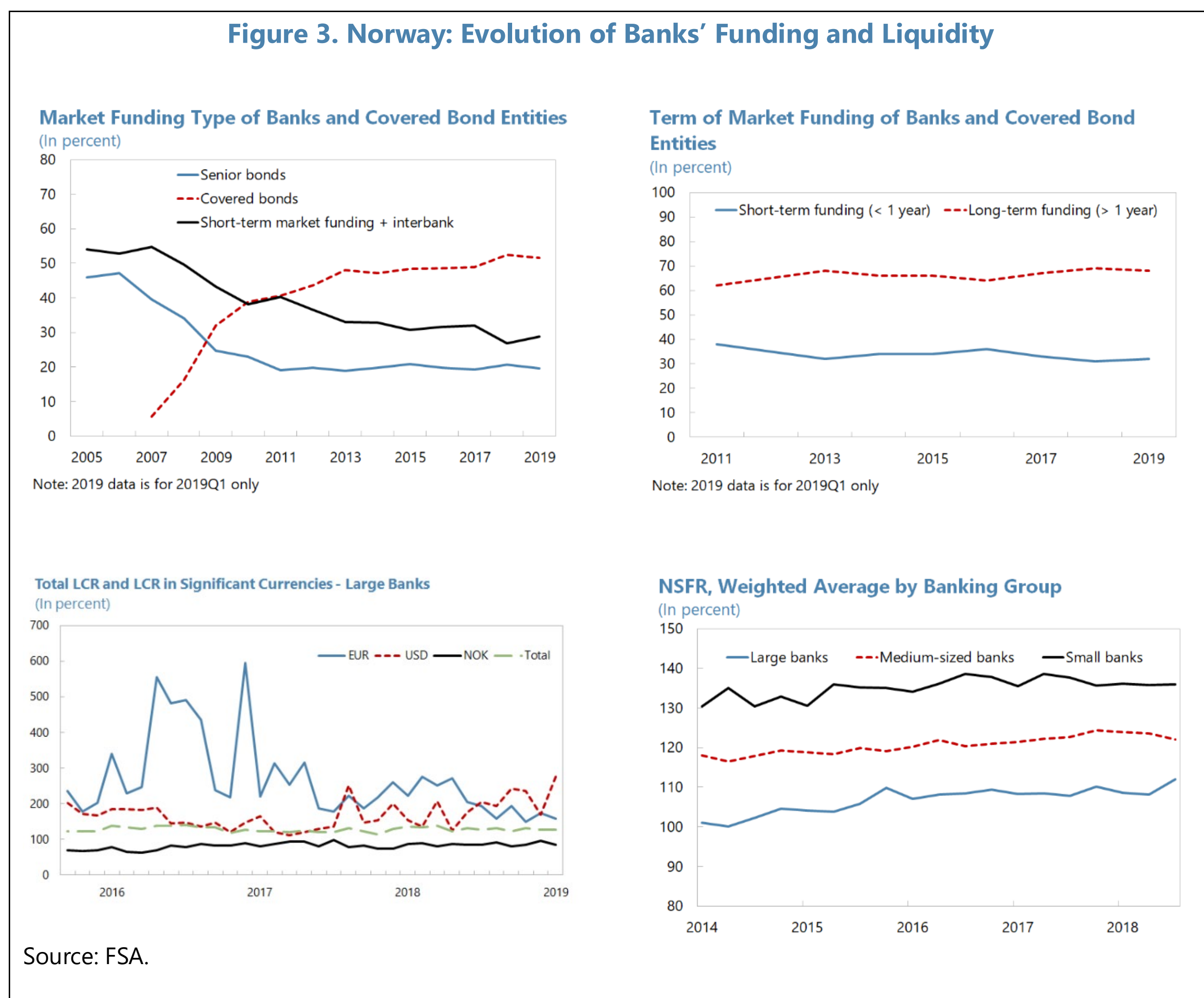
## D. Liquidity Risk

**77. Norwegian banks depend to a significant extent on market funding and their liquid assets comprise a considerable amount of covered bonds.** Funding consists mainly of customer deposits and market funding, but the latter has a significant share particularly in the largest banks. However, the term of market funding has also increased over the past few years. In addition, covered bonds represent a significant portion of bank's funding and of their liquid assets. Given the high reliance on foreign currency funding (particularly in EUR and USD), banks have currency mismatches that they typically hedge using foreign currency swaps.

**78. The regulatory framework and the supervisory procedural manuals include thorough requirements and guidelines on liquidity risk management.** The Financial Institutions Act and the regulation on sound liquidity management establish the main liquidity risk management requirements of banks and the actions that could be taken by the FSA to address gaps in this area. The FSA has also developed two supervisory modules for onsite examinations regarding liquidity funding and risk, one dealing with the liquidity and funding risk levels and the other discussing liquidity risk management and controls. Most of the risk indicators detailed in the module for liquidity and funding risk levels are also monitored by the FSA (based on the mandatory monthly and quarterly reporting from the financial institutions) and used in the SREP-process as well as reviews of banks' recovery plans.

**79. The minimum quantitative liquidity prudential requirements in Norway mirror the EU CRD IV and CRR.** The LCR requirements has been in force since end 2015 and shall be met at all times based on solo and consolidated level. In addition, minimum requirements for LCR in significant currencies have been applied since September 30, 2017. For banks that have significant exposures in foreign currencies, there is a minimum LCR requirement in foreign currencies, mainly EUR and USD, of 100 percent. For those banks with LCR requirements in foreign currency, they also have a minimum NOK LCR requirement set at 50 percent.[24] However, the FSA does not require banks to conduct a separate analysis of their strategy and their liquidity needs for each significant currency. All banks and banking groups also report their NSFR on a quarterly basis. The reporting includes NSFR in significant currencies, but this reporting is given less weight in a supervisory context. There is currently no minimum NSFR requirement in Norway, but the authorities plan to implement the requirement in accordance with the EU process or earlier. However, banks with an NSFR below 100 percent are flagged and closely monitored. Furthermore, since the NSFR has a one-year horizon, the FSA monitors on a quarterly basis the average remaining maturity of a banks' market funding beyond one year and compares it to the banks' peer group.

[24] For institutions with neither EUR nor USD as significant currency, there is no explicit minimum requirement with respect to LCR-NOK. However, their LCR-NOK is monitored by the FSA on a monthly basis.




**80. The lenient treatment of banks' covered bonds in the EU framework and the heavy reliance on these instruments may overestimate banks' LCR levels compared to international requirements.** A key deviation of the EU's LCR framework is the inclusion of instruments as high-quality liquid assets (HQLA) that do not qualify as such under the BCBS's LCR standard. These include high-quality covered bonds, in particular those with a high credit rating (i.e., at least AA- or 10 percent risk weight) and minimum issue size of EUR 500 million, as Level 1 HQLA.[25] Under the Basel LCR framework, qualifying covered bonds rated AA- or higher are accepted as Level 2A assets with a haircut of 15 percent.[26] According to the regulations transposing LCR in Norway, at least 30 percent of liquid assets shall be Level 1 assets excluding covered bonds, which means that high-quality covered bonds can account for a major portion of Level 1 assets. Figure 4 shows the portion of covered bonds in banks' LCR buffers at end Q2-2019, which indicates a high concentration of

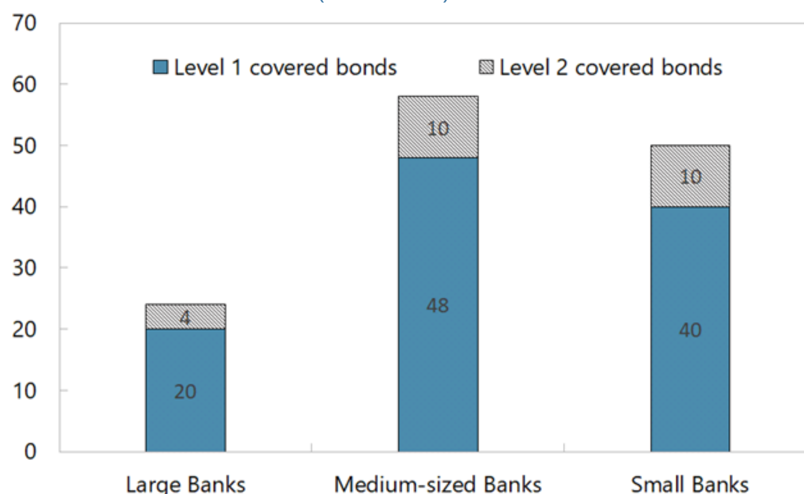
[25] See the Basel Committee on Banking Supervision Regulatory Consistency Assessment Programme (RCAP)—Assessment of Basel III LCR regulations—European Union, July 2017.

[26] As per the EU framework, covered bonds meeting the high-quality criteria are subject to a cap (cannot represent more than 70 percent of the HQLA) and a minimum haircut of 7 percent.

these instruments in banks' liquid assets. The favorable treatment of these instruments and their significant share in banks' liquidity may exacerbate banks' liquidity risks given the cross-ownership of such instruments among banks and their correlation with the real estate market. However, with the low volume of outstanding Norwegian government bonds, due to the financial situation of the Norwegian government, and the risk weighting of Norwegian municipality bonds (only qualified for level 2), LCR level 1 eligible assets denominated in NOK other than covered bonds, are limited. To mitigate the challenges caused by the banks' high reliance's on covered bonds and the Norwegian real estate markets, the FSA encourages banks to conduct liquidity stress tests based on severe price falls in the housing market and increased default ratios for mortgage loans. The FSA itself has over a few years done a stress test at year-end of the Group 1 and Group 2 banks' financial strength given a 30 percent price fall in the housing market.

**Figure 4. Norway: Share of Covered Bonds in Banks' LCR Buffers**

(In Percent)




Source: FSA

**81. While the FSA performs a range of supervisory activities to assess banks' liquidity situation and risk management, some of these activities could be further enhanced.** The liquidity risk management aspects (including strategies, policies, and limits) and funding strategies and policies are primarily assessed during on-site inspections, either during a full inspection (which targets mostly small banks) or a targeted inspection. However, there were very few targeted inspections focusing on liquidity risk management aspects over the last three years.[27] The FSA inspection plan for 2019 included a significant increase in targeted onsite inspections on liquidity and market risks and the FSA reported that all these inspections have been realized by the end of

[27] Over the last three years, there were six targeted inspections on market and/ or liquidity risks. Furthermore, these risk areas where included in six of the more comprehensive inspections in the larger banks (i.e. banks categorized as group 1 and 2 in a SREP context). Targeted liquidity and market risk inspections are normally not conducted in smaller institutions (group 3 and 4), but these areas are included within the twenty general inspections conducted in these smaller banks over the last three years.

November 2019. Banks' liquidity is also assessed through the yearly risk assessment for the largest banks and the SREP work.

**82. The FSA relies on banks' liquidity and funding stress tests in formulating its assessments but further analysis of the implications of banks' exposures in significant currencies is warranted.** Reviews of stress tests are also usually done during onsite inspections, although the FSA together with Norges Bank developed in 2018 a liquidity stress test. The stress test has, however, to be made more frequent and included in the ongoing off-site monitoring. Banks are expected to conduct stress tests covering both bank-specific and market stress scenarios. The findings and outcomes of such stress tests should be reflected in the banks' overall liquidity strategy and risk framework as well as the contingency and funding plans which are also examined by the FSA onsite. However, the FSA does not require banks to include the level of currency mismatches in each significant currency as part of the stress tests. While the banks usually hedge these mismatches using FX swaps, it may be useful to assess the implications of these mismatches and the effectiveness of these hedges in stressed periods.

**Recommendations**

**83. There is scope to strengthen the liquidity monitoring and oversight framework by analyzing banks' liquidity risk profiles and supervising their liquidity risk management.** The following actions could be envisaged:

- Enhance the prudential liquidity risk management regulations by requiring banks to formulate a strategy and assess their liquidity needs in each significant currency, conduct liquidity stress tests in each significant currency (particularly foreign currencies), introduce NSFR as a binding requirement, and continue reporting of NSFR in significant currencies.

- Monitor the banks' reliance on covered bonds in their liquidity and funding, and the implications of the more lenient treatment in the EU framework and ensure that banks have adequate liquidity buffers, particularly to cater for the risks associated with cross-ownership of covered bonds and their interaction with the real estate market.

- Further strengthen supervisory processes and practices with respect to assessing liquidity risk management and adequacy by performing more frequent targeted and thematic reviews over liquidity and funding risk management.

## E. Market Risk

**84. Market/trading risk exposure is not a material risk class for most Norwegian banks and the market risk rules are applied proportionately.** Market RWAs represent a very small proportion of total RWAs (approximately 0.5 percent). A bank with a trading portfolio of less than five percent of total assets and a gross exposure less than EUR 15 million is exempted from calculating capital for market risk. As a result, only 6 banks report market risk while the other banks treat any trading exposures through a banking book treatment for capital purposes. These could

include for example portfolios of shares held for strategic or investment purposes or portfolios of securities and financial instruments related to liquidity purposes. Such exposures are typically risk-weighted at 100 percent.

**85. Norway's regulations are regularly updated to take account of the EBA's implementation of the market risk framework.** Current regulations in effect in Norway follow the EU framework. Once CRD IV and CRR are adopted as part of the EEA Agreement, the EU legislative framework will come into force. Norwegian legislation is not yet updated to take account of the latest global market risk standard (FRTB), which will be adopted based on the EU roadmap and timeline.

**86. Supervisory guidance on market risk is thorough**. The FSA's supervisory guidance on market risk is set out in its assessment of market risk management (i.e., guidelines for assessing the level of a bank's market risk as well as the quality of its risk management and control) and assessment of risk exposure. Currently, no Norwegian banks use the internal models approach for market risk. For larger banking institutions, there are inspections focusing on market risk only. For the smaller banks, the review of market risk management is part of the overall assessment of risk management and control in the bank. Any inspection in smaller banks is normally a general inspection covering all risk areas. The FSA performs a simplified SREP review every year for all banks under supervision, but market risk is not covered in detail in the simplified SREP. A detailed SREP review with written feedback is performed every year on systemically important banks and every other year on other large banks under supervision. A detailed SREP is performed on smaller banks every third year or depending on risk assessment.

## F. Operational Risk

**87. The regulatory framework for banks' management of operational risk is extensive and covers a wide range of laws and regulations.** The various laws and regulations pertaining to operational risk include:

- Financial Supervision Act (LOV-1956-12-07-1), Article 4c (outsourcing)
- Financial Institutions Act (LOV-2015-04-10-17):
- Money laundering Act (LOV-2018-06-01-23)
- Regulations on capital requirements (FOR-2006-12-14-1506)
- CRR/CRDIV regulations (FOR-2014-08-22-1097)
- Financial Undertakings regulations (FOR-2016-12-09-1502)
- Regulations on use of information and communication technology (FOR-2003-05-21-630)
- Various prudential regulations, including prudential reports and public disclosure requirements.

**88. The FSA's supervisory guidance relating to operational risk is likewise extensive.** The FSA's risk-based approach to supervising operational risk is comprised of its operational risk module and used together with the "Module for assessment of corporate governance, management and control." The operational risk module is used by on-site inspectors to assist them in gauging the level of an institution's operational risk and the quality of its management and control of such risk. The module also sets out the FSA's expectations for banks' effective management and control of operational risk. Evaluation of a bank's policies, practices and procedures related to management of operational risk is an integral part of general on-site supervision and the FSA verifies that boards of directors have approved the relevant documents. The FSA uses questionnaires, supervisory-based assessments and other tools, such as regular meetings and correspondence with banks and their ICT providers. Moreover, operational risk issues (including AML/CFT issues) were assessed in most of the FSA's 2018 on-site inspections and, as part of the SREP, the FSA evaluates whether an institution's operational risk profile and risk appetite are consistent with the firm's capital strength. In the FSA's view, operational risk has increased in recent years, and it has therefore required banks to have additional Pillar 2 capital.

**89. While the regulatory and supervisory frameworks are extensive, there continues to be a strong focus on ICT risks with consequent less focus on non-ICT operational risks.** The previous FSAP noted that the FSA's operational risk guidance on non-ICT topics was limited and recommended that the FSA enhance guidance on (i) banks' information systems for monitoring and analysis, (ii) reporting to the supervisor, and (iii) outsourcing. The FSA has adopted enhancements related to these three areas. The FSA notes the increasing importance of ICT risk as an element of operational risk and has focused on ICT topics, such as outsourcing, disaster recovery and business continuity.

**90. The last FSAP further urged the FSA to develop detailed guidance on managing risks arising from outsourcing.** Progress has been noted regarding outsourcing oversight. The FSA requires banks, prior to outsourcing specific functions, to provide a 60-day notification, which sets out a description of the function and the bank's risk assessment. In 2018, it received 161 notifications. In addition, upcoming potential legislation may contain detailed rules on outsourcing. Nevertheless, there are no specific requirements for the outsourcing of risk management nor is there enhanced supervisory practice based on the guidance especially for small banks.

### Recommendations

**91. The FSA should further enhance its regulatory requirements and guidance for operational risk.** In particular, the FSA should:

- Develop specific requirements for the outsourcing of risk management and enhanced supervisory practice based on the guidance especially for small banks.
- Expand its operational risk guidance and oversight to take greater account of non-ICT operational risk management.

# FINANCIAL INTEGRITY

**92. A new AML/CFT Act and regulation came into force in October 2018 and have strengthened AML/CFT related requirements and powers**. The new Act transposes relevant EEA legislation corresponding to the EU's fourth and parts of the fifth AML Directive (directive 2015/849). It also implements a number of FATF recommendations. The new legal framework sets clearer requirements for supervised entities to carry out risk assessments and implement risk-based approaches and procedures in their management of ML/TF risks. It also sets stricter requirements for supervised entities to implement customer due diligence and conduct additional examinations and ongoing monitoring based on risk assessments. The Act also strengthens reporting requirements (including on suspicious transactions) and introduces a legal basis for supervisors to impose administrative fines and sanctions for violations of the law and regulations, as well as an expansion of criminal liability.

**93. The FSA has been working on strengthening its supervisory approach to AML/CFT over the last few years.** In 2016, a first risk assessment of supervised entities was developed and updated in 2018. A new version with a new methodology was finalized in the first quarter of 2019. This risk assessment helps in identifying supervisory priorities and planning supervisory activities. A third national risk assessment was also developed in 2018, with input from the FSA as one of several agencies. A risk classification model has been developed to rank institutions' inherent ML/TF risk based on a number of factors.[28] The model helps in prioritizing supervisory activities over specific entities and areas. However, the model is still new and its reliability as an indicator of the ML/TF risk profile of institutions needs further testing. As the model is being further developed, it is important to ensure that the FSA relies on additional information and input, as well as its own judgment, about banks' ML/TF risks and the effectiveness of AML/CFT controls in the prioritization of its supervisory activities.

**94. Additional resources have been dedicated over the last five years and organizational changes have been recently adopted to further strengthen supervisory capacity in AML/CFT.** Between 2014 and 2018, the FSA almost doubled its AML/CFT resources to about 10.5 FTEs. However, these resources were not centralized and were carrying their AML/CFT tasks as part of their other tasks in the seven sections of the FSA. To fulfill the additional objective of fighting against crime set in the FSA's 2019−2022 strategy, five new staff members were recruited in early 2019 to enhance supervisory capacity. In addition, a more centralized approach to AML/CFT was adopted by establishing a new section for AML and payment institutions in April 2019. This section will be responsible for AML/CFT supervision in various supervised entities and will handle licensing of payment and e-money institutions and virtual currency providers. The section will also be responsible for AML/CFT regulation and international cooperation on AML/CFT.

[28] Over 30 data points or risk factors are reported by the institutions and further data is added by the FSA. These factors reflect size, domestic / international exposure, geographical risk, exposure to higher risk persons and businesses, product types, etc.

**95. The FSA has also stepped up its AML/CFT inspection activities over the last few years, but more can be done to further increase the frequency and scope of AML/CFT inspections for banks.** AML/CFT issues are covered as part of the standard full scope inspections or through targeted or thematic AML/CFT inspections. AML/CFT issues were covered in 73 inspections over banks, credit and financing institutions during 2014-2018. The number of inspections has increased throughout the years but AML/CFT issues were mostly covered through standard full scope rather than targeted inspections. AML only inspections of banks, including foreign bank branches, were very few during the last three years although AML is generally covered in standard inspections. In addition, there were no thematic AML/CFT inspections over the last few years. There appears to be scope to further increase AML/CFT inspection activities for banks, particularly through targeted and thematic inspections. With the recent restructuring of AML/CFT activities and the increased resources, the FSA plans to increase its thematic AML/CFT inspections from 2019.

**96. The cooperation between the FSA and Norway's FIU, Økokrim, has been enhanced to allow for more frequent exchange of information.** Cooperation was formalized through signing of an MoU between the two agencies that laid the ground for coordinating their activities and actions. The FSA and Økokrim exchange information for the purpose of individual inspections as well as on higher-level operational and strategic issues. There is ongoing collaboration between the two agencies on new developments related to supervised entities and emerging threats and concerns. In addition, the FSA uses the information received from Økokrim in calibrating its supervisory priorities and informing its supervisory activities, particularly onsite inspections.

**97. The Financial Action Task Force (FATF) has undertaken a number of assessments and reviews of Norway's AML/CFT regime.** The latest FATF follow-up assessment has been completed in December 2019 and was focused on effectiveness. The assessment noted that Norway has worked to improve the effectiveness of its national framework to combat money laundering and terrorist financing. As a result, Norway was moved from the enhanced to the regular follow-up process. The report noted that Norway is now achieving high or substantial levels of effectiveness on five of the 11 key areas identified by the FATF as immediate outcomes of an effective framework to combat money laundering and terrorist financing. The FATF report concluded that Norway must focus on strengthening its effectiveness on the remaining immediate outcomes, including its measure to ensure appropriate supervision, monitoring and regulation of financial institutions and lawyers, real estate agents and other non-financial entities, and to ensure that the proceeds of crime are confiscated.[29] For more detailed on the findings of the various FATF assessments, see Box 4.

[29] The report and its conclusions are available at the following link. https://www.fatf-gafi.org/publications/mutualevaluations/documents/fuar-norway-2019.html

## Box 4. FATF Assessments of Norway's AML/CFT Regime

**Norway underwent a mutual evaluation by the FATF in 2014, which concluded strategic technical compliance shortcomings and rated the level of effectiveness of AML/CFT supervision and preventive measures as moderate.**[1] The mutual evaluation report noted that banks, particularly the largest, are exposed to high risk of ML and that supervisors did not adequately understand ML/TF risks. It also noted that the FSA conducted limited AML/CFT supervision, mostly in the context of prudential and business conduct supervision and focused on technical compliance checklists rather than on the effectiveness and robustness of the AML/CFT preventive measures implemented. While serious breaches of basic compliance had been identified, supervisors did not have a wide enough range of powers to sanction, and no sanctions other than written warnings had been applied. The assessors concluded that there were significant weaknesses regarding the implementation of key preventive measures related to beneficial ownership of bank accounts' holders, politically exposed persons, wire transfers, correspondent banking and ongoing monitoring. They also raised concerns over the quantity and quality of suspicious transaction reports, which predominantly related to cash-based transactions.

**The legal AML/CFT framework's strengthening led to upgrades in technical compliance ratings.** Legal reforms, including the adoption of a new AML Act and Regulations in 2018, resulted in higher ratings on 20 (out of 40) FATF Recommendations. Norway is currently compliant or largely compliant with 35 recommendations. In particular, technical compliance of measures regarding customer due diligence, record keeping, politically exposed persons, internal controls and group-wide programs for foreign branches and subsidiaries were strengthened. The powers of supervisors have been enhanced and administrative sanctions and bans on managers can be imposed for breaches of the AML Act's requirements.

**FATF's 2019 follow-up assessment noted progress in several areas. The FSA has initiated specialized AML/CFT inspections, with a focus on high-risk institutions.** An AML/CFT component is now included in all standard inspections and has been expanded. The FSA has also established and implemented risk classification models and supervisory modules to support its AML/CFT supervision. However, the assessors noted that although FSA has taken actions to ensure that its supervision is based on identified ML/TF risk, the scope, intensity and frequency of its supervision is insufficient and not always commensurate to the level of risk identified. In addition, the FSA gradually increased its resources dedicated to AML/CFT, from 5 full time equivalents (FTEs) in 2014 to current 13,5 FTEs.

**However, the FATF concluded that there has been insufficient progress on AML/CFT supervision, and the level of effectiveness remains moderate.** The areas for improvements include enhancing further FSA's supervisory methodology and resources, adjusting supervisory activities proportionate to the level of ML/TF risks, particularly in branches of foreign banks, determining the frequency of inspections for higher-risk banks according to a policy or supervision manual, and taking actions to address identified breaches of the AML Act, including by using the newly granted sanctioning powers.

[1] There are four ratings of effectiveness: low, moderate, substantial, and high.

**98. The FSA has taken some measures to address AML/CFT weaknesses in banks and has imposed two fines.** Through its AML/CFT supervisory activities, the FSA has found some weaknesses in AML/CFT frameworks. These weaknesses involve mostly the adequacy of risk assessments, the effectiveness of customer due diligence policies and processes, the handling of high-risk customers and activities, the policies for correspondent and respondent banking relationships, and the adequacy of AML/CFT resources. A number of cease and desist orders were issued in 2018 and 2019 to require the supervised entities to correct their situation. In these orders, the FSA threatened to impose coercive fines on the concerned entities if the orders were not complied with. The FSA reported that the coercive fines were not imposed due to adequate follow-up from the entities in questions. Two administrative fines were imposed on banks in 2019. It would be useful to review the effectiveness of the current approach to corrective actions and the extent to which it can be enhanced by taking a more active stance in applying sanctions and fines.

**Recommendations**

**99. Progress has been made in enhancing the AML/CFT legal and regulatory framework and the FSA supervisory approach, but more actions are needed to increase FSA supervisory resources and oversight.** These actions need to continue to further upgrade the current approach and processes and ensure their effectiveness in addressing AML/CFT weaknesses in the banking sector. To that end, the FSA is recommended to:

- Increase its AML/CFT onsite inspections over banks, including branches of foreign banks, particularly in the form of targeted and thematic inspections.
- Further improve its risk-based approach to AML/CFT by enhancing its risk classification model to ensure its reliability as an indicator of ML/TF risks and by developing its AML/CFT supervisory tools and methodologies.
- Continue to use the new sanctioning powers as appropriate and review the effectiveness of their use, with a view to ensure a more active approach in dealing with AML/CFT weaknesses and deficiencies.