NORGES BANK'S

FINANCIAL STABILITY REPORT:

A FOLLOW-UP REVIEW

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I. INTRODUCTION

1. This report follows up on the review of the Norges Bank's *Financial Stability Report (FSR)* that was undertaken by the same three person panel in early 2003. The terms of reference for the 2003 review were described by the Norges Bank as follows:

> "Although the methodology which has been built up over time in different areas has enabled us to develop our stability report further, we believe that regular expert reviews may have a positive influence on further developments. Moreover, we would like to have our reports assessed relative to those produced by other central banks: how we stand with respect to the methodology applied, in particular credit risk, and how we should focus resources in order to maintain overall high quality. At the same time, the format and scope of the report have been very much designed to make accessible to policy makers, financial institutions and the general public issues that may be rather intricate in analytical terms as well as in terms of resolution methods."

2. One of the earlier panel's recommendations was that it undertake a follow-up review of the FSR in one to two years' time to assess the actions taken by the Norges Bank as a result of the initial review and to discuss any questions that may have arisen. When convening the panel for this follow-up review, the Norges Bank additionally requested that the panel provide their views on how the FSR could better take account of several issues of current relevance to financial stability in Norway, including: (a) the implications of multinational banks operating in Norway; (b) financial sector concentration; and (c) the findings of the recent assessment of Norway's financial system by the IMF under the Financial Sector Assessment Program (FSAP).

3. The panel met in Oslo with the Norges Bank staff, including the Governor and Deputy Governor, to discuss these issues on September 5-6, 2005. This report, summarising the panel's conclusions, is organized as follows. First, there is a brief discussion of the extent to which the conclusions of the previous review were implemented (more detail is provided in the Annex). Second, the report discusses how the coverage of the FSR might evolve, both as regards the areas requested by the Norges Bank as well as several additional areas. Finally, a few minor suggestions are made regarding changes to the coverage of the data and tables which are included in the FSR.

4. The panel would like to reiterate the view presented in our earlier report, and echoed also by the IMF during the FSAP, that the Norges Bank's FSR is an exemplary example of a stability report, and the actions that have been taken since the last review by the panel have only improved it further. The Bank is therefore to be congratulated for the report's consistently high quality. The recommendations for further refinements which are made in this report are thus very limited in scope.

5. The panel also previously noted that the interlinkage between financial stability and monetary policy is more clearly recognized in Norway than in some other countries, through the consideration of financial stability implications in the monetary policy decision making

process, through the analysis of the implications of financial sector developments for the inflation outlook, and in the FSR and the Inflation Report. This continues to be a strength of the financial sector stability work of the Norges Bank.

II. Status of the Previous Recommendations

6. The Norges Bank has taken actions, or has plans in place, regarding virtually all of the panel's earlier recommendations. During the earlier review, it was noted that various definitions of financial stability are possible. It was suggested that to help focus the FSR on its target audiences, the Norges Bank should review its definition of financial stability. This has been done, with the result that the broader definition, which is provided at the beginning of each issue of the FSR, was adopted as being more closely aligned to the desired scope of the FSR. In revisiting the issue of length and scope during the follow-up, the panel continues to feel that the length of the FSR is about right.

7. The panel also found very interesting the presentation that was made during the meetings with Norges Bank staff on progress with the ongoing macro-modeling project at the Norges Bank, which involves in part the development of a financial stability satellite to the Bank's new core-macro model. The panel noted that the use of the macro-model makes simulating extreme shocks difficult, due to the model's tendency to revert relatively quickly to an equilibrium. The individual equations in the satellite nevertheless are providing useful results, for example as regards the likely upward trend in household debt servicing ratios even if house prices stabilise. Other projects to analyse specific risks, such as the SEBRA model analysing credit risk in the enterprise sector and the adoption of the SMM model to quantify foreign exchange rate risk as well as other macroeconomic risks, also seem to be producing very useful results.

8. The panel welcomes the addition of standardized tables at the end of the report and the work that has gone into simplifying the amount of information contained in charts and graphs. Many of the topics that the panel had suggested could be covered in the FSR had been covered well as special topics in boxes.

9. A more detailed review of the extent to which previous recommendations have been implemented is provided in the Annex to this report.

III. Additional Issues of Relevance to Financial Stability

10. When considering how the FSR might be modified to better take account of new areas of relevance to financial stability, the panel's starting point is that a key objective of the FSR is to inform the Norwegian government and the public about the Norges Bank's monitoring of the Norwegian financial system's stability, including the analysis of the interrelationship between monetary policy and financial stability. Within this framework, there does seem to be some room to expand the coverage of the FSR, including in the areas which the panel was requested to review, especially now that the FSR is explicitly focused on a relatively broad definition of financial stability. Coverage should primarily be through the

analysis of additional special topics from time to time, rather than by expanding the core elements which are covered in every issue.

Multinational banks and financial sector concentration

11. The panel is of the view that the impact of the activities of multinational banks and increased financial sector concentration are both suitable topics for the FSR to address. As both are seen as sources of potential risk for financial system stability, the FSR can communicate to its audiences the kinds of risks that have been identified by the Norges Bank and also that thought is being given as to: (a) how to minimize them; and (b) how problems will be addressed should they arise.

12. Care would need to be taken as both these issues are of particular relevance to individual Norwegian financial institutions. Discussion of these issues in the FSR could raise the understandable concern that increasing public awareness of financial stability issues could possibly exacerbate the problems identified. That being said, it is no secret which institutions are more heavily affected. With care, it could be possible to discuss the nature of the risks arising from multinational banks and financial sector concentration in general terms, without implying that there are weaknesses in specific institutions or their managements.

13. As regards how future problems might be addressed, a good crisis management framework will rest on an effective on-going mechanisms for information sharing and close coordination already being in place, at both top management and operational levels, between all the relevant bodies in Norway (the Norges Bank, Kredittilsynet and the Ministry of Finance). The FSR could point out these structures and arrangements so as to enhance public confidence in the financial system. It could also be useful to highlight the lessons of any crisis management exercises undertaken in conjunction with other countries. Along the same lines, it might be worth at some stage reporting on any crisis management exercises that have been undertaken by the Norwegian authorities in conjunction with other countries.

14. As regards financial sector concentration, there may be scope to do more work on whether banks share common concentrations at different levels of aggregation (Norway, the Nordics, Europe, etc.). Alternatively, an analysis of whether banks behave as if they face common risk factors (e.g., do their share prices or CDS premia move closely together) might be interesting.

FSAP recommendations

15. The recent FSAP for Norway did not raise many issues that warrant discussion in the FSR. The FSAP' team's conclusions about the Norwegian financial system and the supervisory and regulatory framework were very positive. As already noted above, the FSAP team reviewed the FSR and found it to be a model for such reports.

16. One issue that was raised in the FSAP, however, and which could potentially be looked at in the FSR, is the extent to which there is a need to develop longer term investment

instruments to satisfy demand from pension funds. More generally, the FSR could look at the question of whether the Norwegian authorities can and should attempt to promote the development of local capital markets. In proposing this as a topic for the FSR, the panel: (i) acknowledges that financial sector deepening and development is not solely a stability issue; and (ii) agrees with the view expressed by the Norges Bank that the FSR is not an appropriate vehicle for initiating debate with the Government on new policy issues.

17. Initiatives to promote financial sector deepening would need to be discussed with the Government, and plans developed, prior to analysis of the stability implications in the FSR. Once such strategies and plans are in place, however, the FSR can be a useful vehicle to communicate with the public and market participants and to build up broad based support for initiatives underway.

18. There may be other such issues that arise from time to time where the Norges Bank wishes to use the FSR to provide its views on aspects of financial sector policy that have potential implications for financial sector stability. The panel's view is not that the FSR should be used as a platform for public debate between official agencies and government on issues where there is not consensus. Rather, on issues where there is consensus, the FSR can be used to promote greater understanding of important financial sector issues and perhaps build support for a particular approach amongst the general public. In such situations, the Norges Bank would no doubt also be presenting its views in more than one way (e.g., in the form of the Governor's speeches or press articles). For greatest effectiveness, covering these issues in the FSR should be part of the Bank's overall communications strategy on those issues.

Financial sector infrastructure

19. Resilient financial infrastructure is a critical element of financial sector stability and infrastructure issues have therefore been regularly covered in the FSR. As infrastructure issues are often of a one-off nature (e.g., new developments in the payment system), the FSR has rightly covered infrastructure issues as individual special issues from time to time. This is also the approach that is commonly taken in many, if not most, FSRs in other countries.

20. This approach to covering infrastructure issues may nonetheless give the impression that infrastructure is not as central to financial stability as some other factors. Consideration could therefore perhaps be given to covering infrastructure issues in a more systematic way. What is being suggested here is not to move away from the approach of looking at individual infrastructure issues as one-off. Rather, the suggestion is to highlight the importance of a robust infrastructure for continued stability, and the potential role of infrastructure weaknesses in contagion, as a general theme. Individual infrastructure issues can then be discussed in this context.

21. Efforts could perhaps be made to include discussion of individual infrastructure issues more frequently than has sometimes been the case, and even perhaps in a separate infrastructure chapter (although there may not be a sufficient number of different issues to

warrant the inclusion of at least one, and therefore an full infrastructure chapter, in each issue of the FSR). In any case, one possible topic for future coverage could be the stability implications of tiering in the payment system for the smaller financial institutions. Another might be the stability implications, if any, of reliance on common service providers, so long as that does not trespass on the responsibilities of Kredittilsynet.

Other possible issues

22. As noted in the Annex, the panel's 2003 report included a number of suggestions for possible special topics for future issues of the FSR. The Norges Bank has followed up on many of these, and informed the panel that they will likely follow up on others in the future. In addition to these, based on developments both inside and outside Norway since early 2003, the panel has the following suggestions for topics which may warrant coverage in the future:

- Implications of the diversity of types of bank in Norway. This could include an exploration of the implications for Norway of the theoretical observation that some banks have more ready access to capital markets than others; the reasons why some banks are relatively lowly rated; and perhaps even the consequences of public ownership of state lending institutions.

- It might be worth exploring the general challenge that central banks face in quantifying/calibrating the extent of systemic risk arising from particular vulnerabilities. Macro stress testing, which is already a central component of the Norges Bank's stability work, is one way into this. Another approach that could be worth considering over the medium term might be to regard the banking system as a single bank and asking how much economic capital it should assign in relation to different aspects of its balance sheet (and activities more generally). Such an approach abstracts from the important question of the nature of interbank linkages, which also needs to be addressed.

- The panel strongly supports the work underway on the stress tests and modeling. The Norges Bank is one of the leaders in this area and there is an audience, both inside and outside Norway, for continued reporting on the development of the analytical techniques. Of particular interest is the work underway in several countries to attempt to better assess liquidity and contagion risks at the system-wide, rather than at the individual bank level. The Bank might also wish to consider modeling bank behaviour as an avenue for future work.

IV. Data and Presentation Issues

23. The panel was impressed by the streamlining of graphs in the FSR, and the inclusion of additional standardized tables in Annex 1 of the FSR. The panel nevertheless suggests that

several further data series could be added to the tables. Consideration could be given to presenting the full core set of financial soundness indicators (FSIs) identified by the IMF.[4] Even if the full core FSI set is not presented, the inclusion in one of the tables of data on non-performing loans (one of the key FSIs) would be welcome. We realize that these data are presented in the charts in the body of the report itself (e.g., Chart 6 in the May 2005 FSR) and that the underlying data are accessible from the Norges Bank website. Nevertheless for ease of access, consideration could be given to presenting the data in the report itself.

24. The panel noted that there has been a move to include a bibliography in each FSR issue, listing research papers relevant to that issue, and especially those which relate to the special topics that are covered. This is a good development, as it provides easily followed links for those interested in getting more detail on specific issues. Along the same lines, it may be worth considering whether there is room for strengthening cross-referencing with other Norges Bank publications (e.g. on FS infrastructure) and perhaps those of Kredittilsynet also. This may not be easy to do in an efficient way.

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[4] See http://www.imf.org/external/np/sta/fsi/eng/fsi.htm.

STATUS OF THE PREVIOUS RECOMMENDATIONS

25. This Annex discusses how, and to what extent, the Norges Bank has reacted to the recommendations made by the 2003 review panel.

General recommendations

26. During the earlier review, the panel focused on the objectives of the Norges Bank in producing an FSR, the intended audiences and, based on that, the appropriate scope and presentation. The panel was of the view that the concise nature of the FSR was a strength, given the desirability of making it accessible to a variety of audiences and given resource constraints. The panel therefore suggested that the FSR should remain at around the same length, with the additional issues they suggested generally being appropriately covered as special topics rather than as additions to the core part of the Report.

27. In revisiting the issue of length and scope during the follow-up, the panel continues to feel that the length of the FSR is about right. The panel noted that a number of the additional topics that had been suggested had been covered well and clearly as special topics in boxes. The panel welcomed the addition of standardized tables at the end of the report and also the inclusion of a short bibliography of analytical papers that underlie the boxes in each issue, as that provides a clear reference guide for readers who wish to explore particular topics in more depth. The bibliographies and boxes, when looked at across issues of the FSR, also provide a good summary of the ongoing analytical work program on financial sector stability that is underway in the Norges Bank. The panel also welcomed the attempt to simplify the amount of information contained in charts and graphs.

Definition of financial stability

28. During the earlier review, it was noted that various definitions of financial stability are possible. It was suggested that to help focus the FSR on its target audiences, the Norges Bank should review its definition of financial stability. This has been done, with the result that the broader definition, which is provided at the beginning of each issue of the FSR, was adopted as being more closely aligned to the desired scope of the FSR.[5]

Evolution of risks in the system

29. The panel previously noted that the FSR could perhaps do a better job of making clear how systemic risks have changed and evolved over time. In some respects, identifying trends in risks is easier than identifying absolute levels of risk and the panel welcomed the

[5] The panel acknowledges that there has been little *de facto* change in the scope of the FSR, but does feel that the broader definition is more closely aligned to the stability work of the Bank and the issues which are covered in the FSR.

inclusion of more commentary on the evolution of risks including in the Summary section of the FSR. The panel also notes the continued emphasis on sectoral breakdowns, as helping the reader to assess relative importance of different risks, and noted the Norges Bank's intention to seek to achieve rough quantifications of exposures in future issues.

30. The panel also welcomed the greater coverage provided to risks in the insurance sector in the May 2003 issue of the FSR. While the panel agrees that the FSR should focus primarily on the banking sector, given its predominant role, there is concern internationally that the transfer of risk off banks' balance sheets onto those of other institutions, such as insurance companies, could over time give rise to unforeseen contagion channels.

The panel also noted the Norges Bank's intention to include as possible special topics in future issues of the FSR a number of their previous suggestions including: (a) the evolution of macroeconomic risks, such as which sectors in the economy are bearing foreign exchange risk; (b) risks arising from the level and volatility in the price of oil; and (c) links between the Norwegian banking sector and the rest of Europe, including possible contagion channels.

Stress testing framework

31. The panel had previously commented that the stress testing framework could be improved, including through: (a) greater focus of the impact of shocks on banks' balance sheets; (b) some more extreme shocks and worst case scenarios; and (c) maintaining scenarios of similar likelihood in successive tests. In that regard, the panel noted the move in the May 2003 report to complement the estimates of how macro-economic developments might affect bank loan losses with estimates of the ability of the largest banks to withstand loan losses.

Greater use of "benchmarking"

32. The panel had previously suggested that greater use of benchmarking against the history and experience of other countries, especially those in the region, could be useful to provide perspective on trends in Norway (e.g., on households' debt-to-income ratios). The panel notes that there has been greater use of benchmarking in recent issues of the FSR. The panel also agrees that benchmarking is complicated due to differences in data definitions across countries: for example, differences in definitions may be one reason why German bank's NPL ratios seem unduly high relative to their European peers.

33. Agreement internationally on standardized definitions of key financial soundness indicators is still some way off. Nevertheless, the panel is still of the view that benchmarking is useful. While differences in data definitions may give rise to differences in levels of particular series, they should have less impact on the underlying trends in different countries. The panel therefore encourages the Bank to continue to make use of benchmarking in the FSR.

Other recommendations

34. Most of the recommendations which the Norges Bank has not yet adopted were of the form of special topics which the Bank expects to cover in future editions. For example, the question of why Norwegian banks, while well rated by rating agencies overall, nevertheless tend to be rated lower than their counterparts in other Scandinavian countries. This seems to be related primarily to the Norwegian banks having a higher proportion of problem loans, and perhaps to their having somewhat higher cost structures, but identifying the reasons with more specificity would be welcome.