



KREDITTILSYNET

The Financial Supervisory Authority of Norway

The financial crisis and Norwegian financial institutions

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The financial crisis and its causes

- ***Bad banking:*** Subprime-loans, sold as securities to investors trusting Rating companies, which did a poor job
- ***Bad policies:*** Too low interest rates for too long. Global imbalances left unchecked.
- ***Bad regulation:*** Half the US Credit market without proper regulation and supervision. Unconsolidated subsidiaries (SIV's) investing in securities (CDO's) based on subprime and other low quality loans.

The rise and fall of Investment banks

- US regulation, capital adequacy requirements and supervision address primarily Deposit-taking institutions
- Investment banks were financed in the market, by bonds sold to pension funds and other private investors
- They became systemic important to the US and international financial markets, without having capital requirements and banking supervision
- From 2003 to 2007 the US investment banks doubled their activity, establishing subsidiaries and branches in a number of countries
- Normal banks lend 10-15 times their own funds. The investment banks typically lend 30 times own funds
- Investment banks played a key role for the liquidity of financial markets and the valuation of financial instruments

The collapse of Lehman Brothers

- USA rescued Bear Stearns, Fannie Mae, Freddie Mac and AIG (insurance), but let Lehman Brothers go 15 Sept.
- No warning, no planning, European institutions with large exposures. CEBS: *"There is no one in charge over there!"*
- Only a minor part of claims were covered. English, German and Italian banks suffered. Swedish and Icelandic banks significantly exposed. Very low Norwegian exposure.
- The Interbankmarket in dollars broke down. Strong impacts on European and Norwegian Interbankmarkets. Difficult to obtain dollars. Several days without quotation of dollar rate and money market interest rates.
- The end of Investment banks: BoA buys Merrill Lynch, Goldman Sachs and Morgan Stanley obtain 22 Sept. banking licences and start reducing their balances.

From financial crisis to an international recession ...

- Bank losses, particularly in US and UK, have drastically reduced banks ability to serve their clients and lend money.
- An artificial credit bubble has to be brought back to a sustainable level for credit.
- This process produces a period of reductions in GDP in all major industrial countries.
- The crisis in the real economy creates new losses for the financial industry, further reducing their lending capacity. Significantly higher risk premiums in credit markets, particularly in internationally exposed industries, reduce trading activity and investments.
- We have a vicious circle which requires a number of strong and new monetary and fiscal measures before it is broken and the recession brought to an end.

Impacts for Norwegian financial institutions

The impacts fall into four main categories (which are somewhat interlinked):

- 1. Direct exposures to failing financial institutions and instruments**
- 2. Reduced access to international liquidity**
- 3. Higher international requirements for capital**
- 4. Reduced real economic activity internationally and domestically**

The latter will be the most difficult to cope with and for the authorities to deal with.

1. Direct exposures to failing financial institutions and instruments

- No direct exposures to American sub prime-loans and CDOs built directly on them
- Most Norwegian banks and insurance companies had limited or moderate exposures to other financial instruments hit by the crisis
- Eksportfinans experienced a significant loss on their liquidity portfolio
- Limited exposures (significantly smaller than other European institutions) to failing institutions like Lehman Brothers and Icelandic banks. No significant Madoff-exposure

2. Reduced access to international liquidity

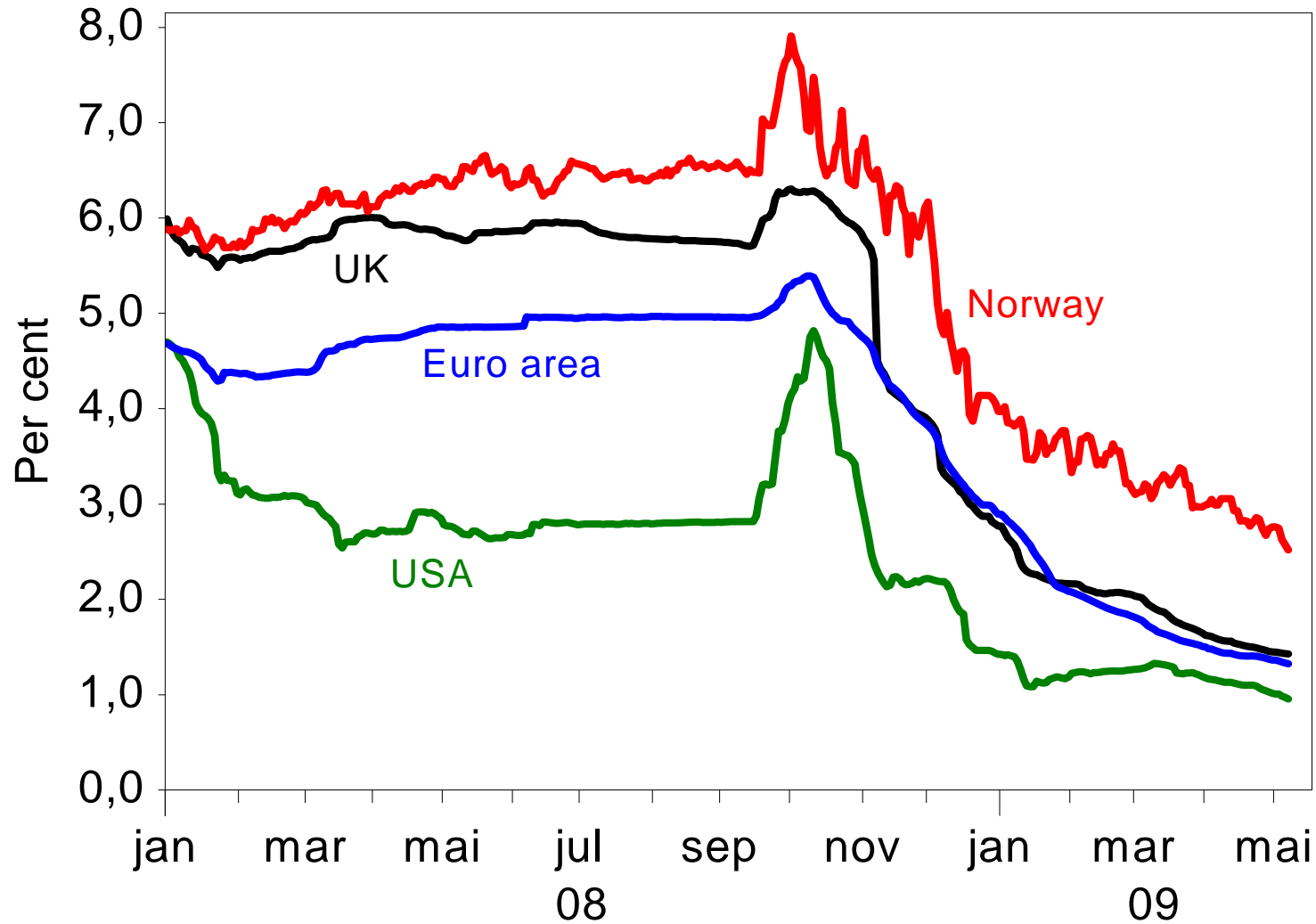
- Two thirds of bank loans covered by deposits
- More than 60 per cent of market funding is borrowed internationally
- The collapse of the international interbank- and money market demonstrated an unexpected vulnerability of Norwegian banks – implying a steep rise in money market rates
- Liquidity reserves were satisfying, but uncertainty for future access to liquidity halted lending of the banks
- Information and rumours of guarantees and other Government measures abroad led to some unrest and transfer of large deposits (>2 mill NOK) from Norwegian banks

Liquidity measures

- Government measures of 12 October decisive for ensuring liquidity and a functioning money market
- Norges Bank supplied in 2008 42 NOKbn in government bonds and certificates by swapping with banks OMF's (preferential bonds). So far in 2009 another 69.3 bn NOK supplied
- From Oct. 2008 Norges Bank issued F-loan of longer duration by 37.2 NOKbn. (12.6 bn 2 years, 2.8 bn 6 months and 21.8 bn 3 months.) So far in 2009 further 22.6 bn F-loan (one auction of 3 years duration).
- 10 new mortgage companies licensed (previously 5)
 - by express procedures in Kredittilsynet: Sp. Vest, Møre, Sør, Nordea, Sandnes, Sogn og Fjordane, Plus, Øst, Helgeland and Fana.

3-month interbank rates

1 January 2008 – 7 May 2009



3. Higher international capital requirements

- Banks' solvency constitutes the basis for normal loan growth and market funding. There is a clear international trend towards higher capital levels that also affects Norwegian banks.
- Banks' credit risk has increased significantly due to the cyclical downturn, but also due to the very strong lending growth over several years, to households as well as to corporates. There is a risk of significant losses that will reduce profitability and solvency.
- Capital buffers of Norwegian banks that were satisfactory in 2008 will not be sufficient in 2009. Heavy losses and capital support for banks in several countries have increased the level and quality of capital required by the market.
- Kredittilsynet signaled in 2008, within pillar 2 in Basel II, that several banks should increase their planned capital adequacy ratios. For appr. half of the larger banks, Kredittilsynet signaled the need for increased actual capital adequacy ratios. Markets' required capital levels have been set higher than supervisors'.

4. Reduced real economic activity internationally and domestically

- **The international financial crisis probably the most serious since the 1930s, and affects all countries and regions.**

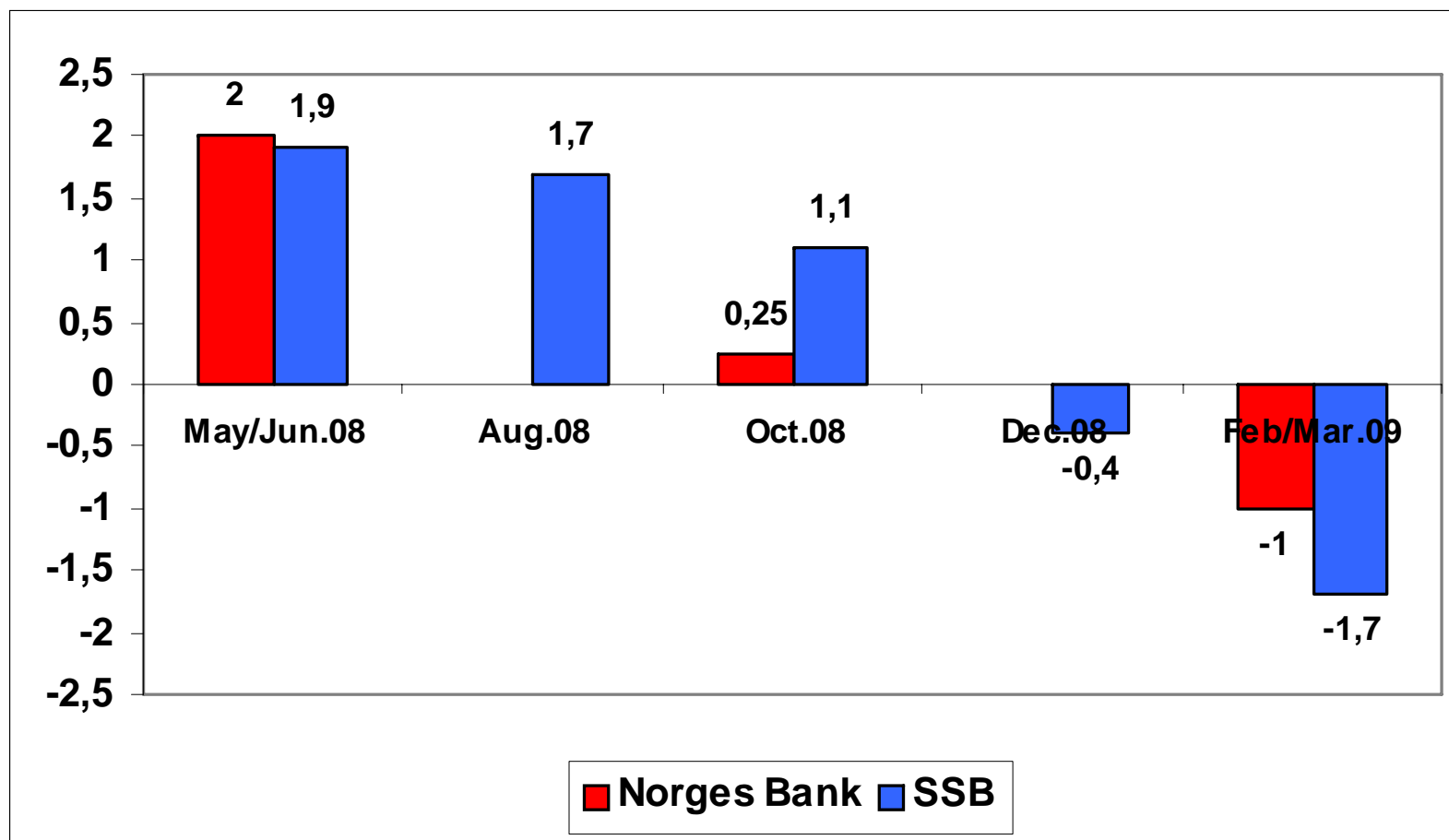
Recession in the US, Euro-area and Japan, and gloomy prospects (deteriorating)

- **”Hard landing” of the Norwegian economy**

Falling manufacturing production and exports, falling consumption growth and housing investments. Increasing unemployment

- Deteriorating profitability in the corporate sector – number of bankruptcies increasing
- A period of falling house prices on 12 month basis
- Reduced credit growth to corporates and households

Growth in Norwegian Mainland GDP 2009 – projections at given times

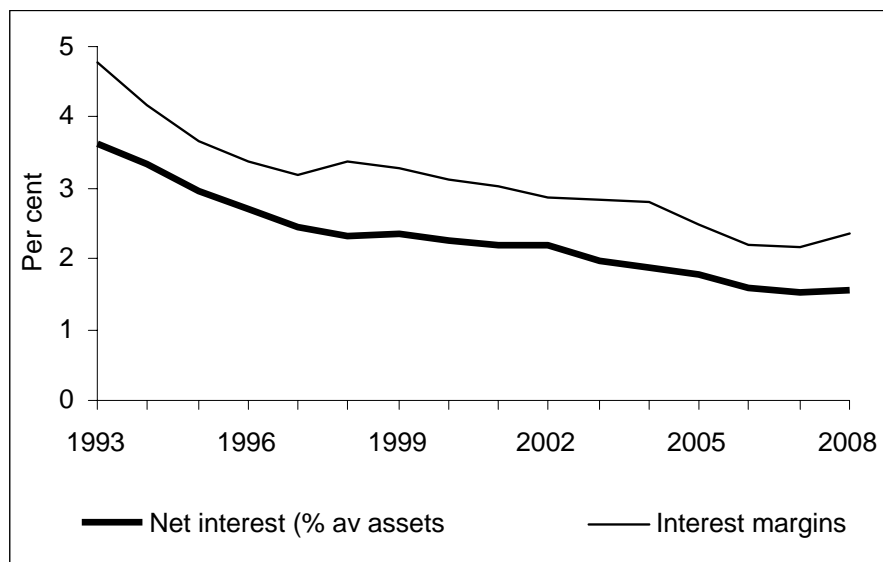


Regulation and supervision in Norway

- Regulation and supervision in Norway have limited the effects of the crisis for Norwegian banks. In Norway, all parts of the financial sector are subject to regulation, capital requirements and financial supervision. (The US, e.g. has a very fragmented system of supervision).
- Kredittilsynet was in 1986 the first integrated supervisory authority among the Western countries. An integrated supervisor means that one institution is given the responsibility for supervising banking, insurance and securities activities.
- A financial institution that establishes a subsidiary must consolidate its accounts and the consolidated company is subject to capital requirements.
- There are strict rules on securitisation in Norway. Securitisation in Norway has only taken place through mortgage companies under supervision and capital requirement.

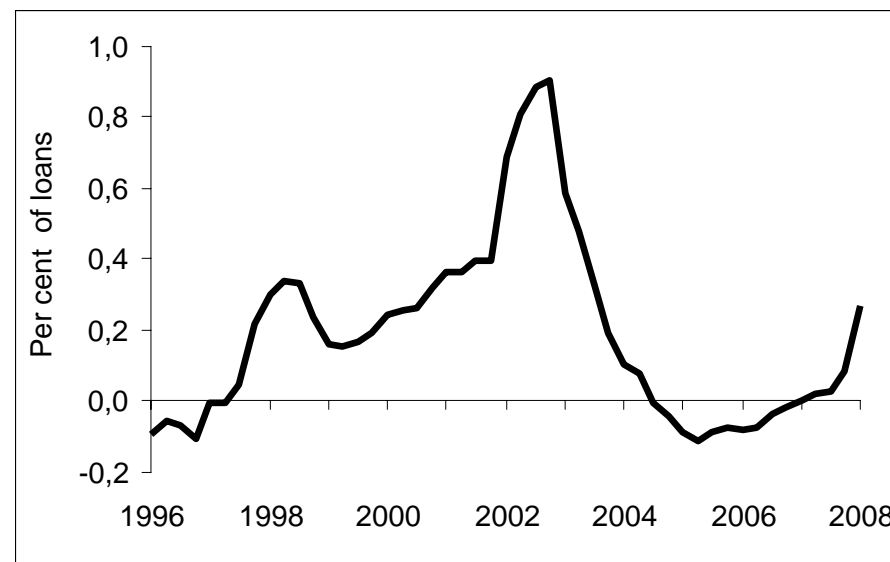
Norwegian banks – margins and loan losses

Net interest income and interest margins



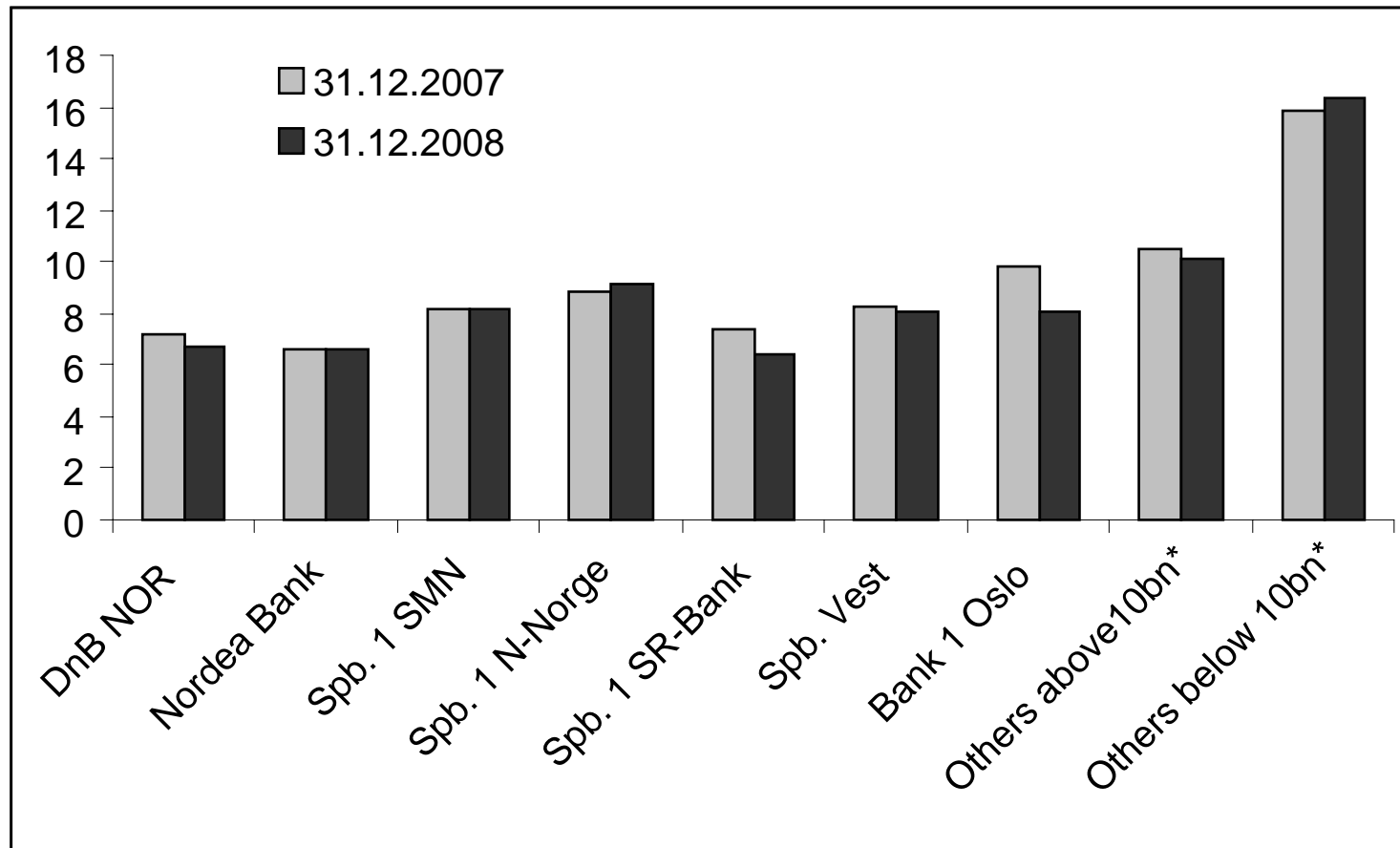
Source :Kredittilsynet

Loan losses (moving average last 4 quarters)



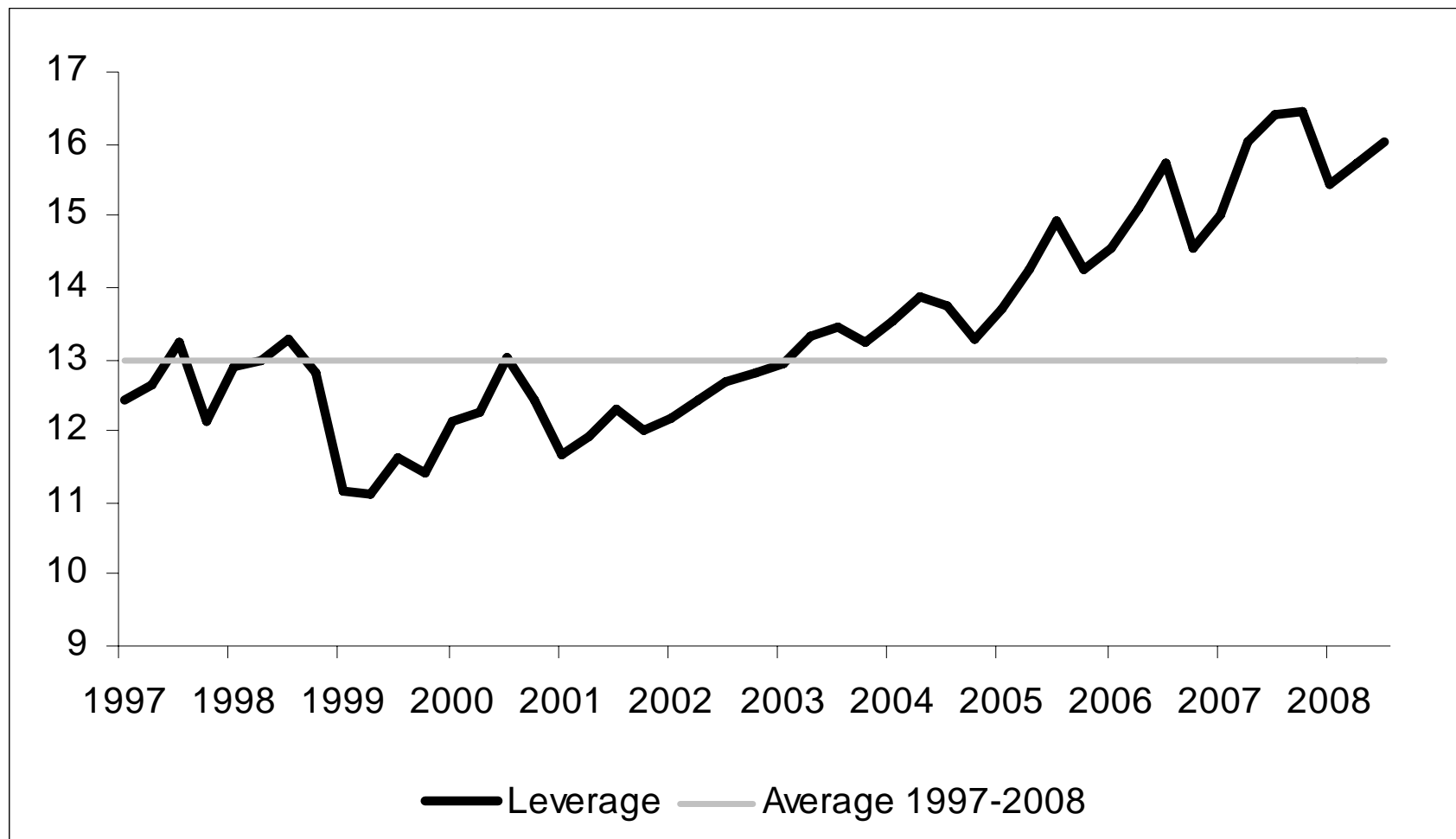
Source: Kredittilsynet

Tier-1 capital – Norwegian banks



* Standardized method. Other banks using IRB-methods.

Norwegian bank's leverage, 1997-2008

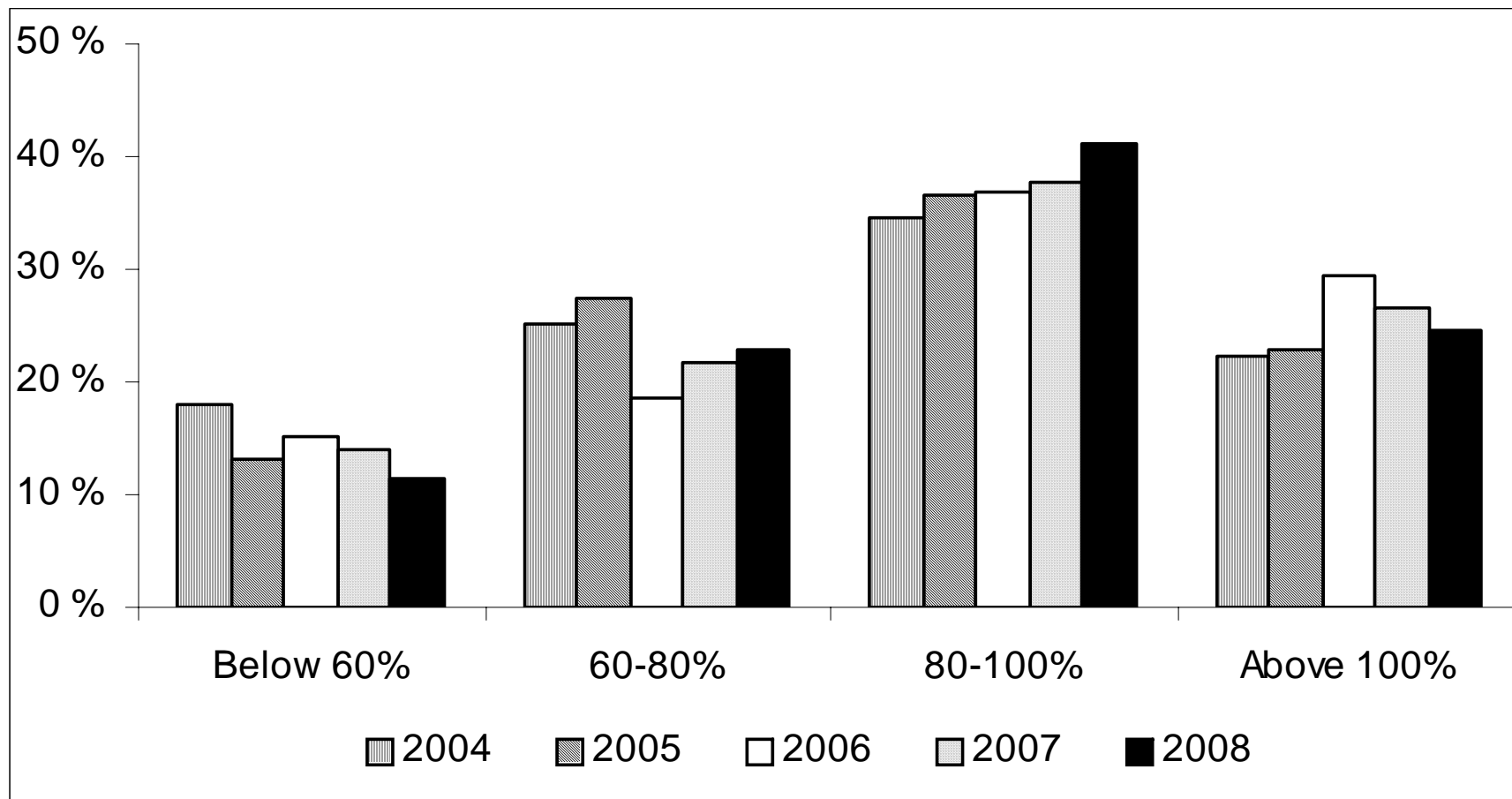


Source: Kredittilsynet

Bank lending practice and low interest rates 2005-07 strengthened the downturn 2008-09

- **Kredittilsynet has in recent years warned against banks lending 100 per cent of house values. More than one third of loans passed this limit in recent years.**
- **The debt burden made many households vulnerable. Higher interest rates in the cause of 2008 and the impacts of the financial crisis restricted spending, stopped new house-building and hit the construction industry hard.**
- **Bank lending practice and the policy of low interest rates of 2005-2007 thus made for a "harder landing" in late 2008 and in 2009/1010 than could have been the case with lower household debts.**

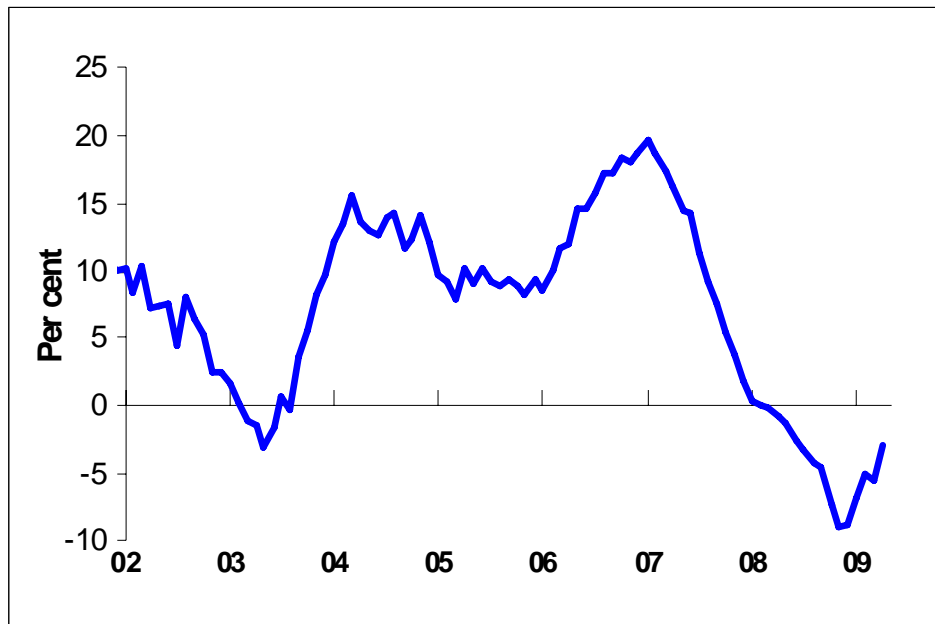
Loan-to-value ratio – house purchase



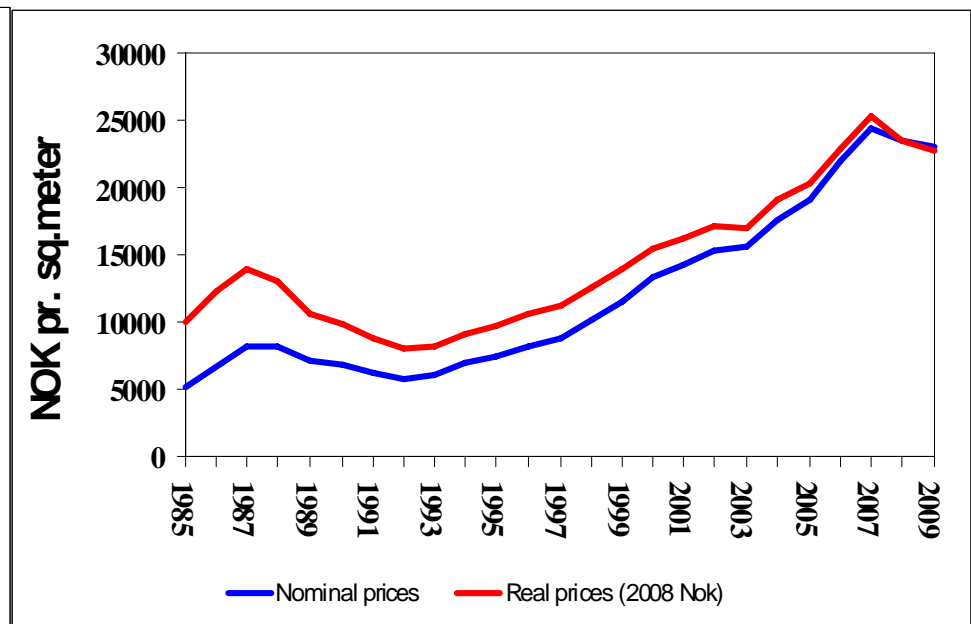
Source: Kredittilsynet

House prices

12-month growth

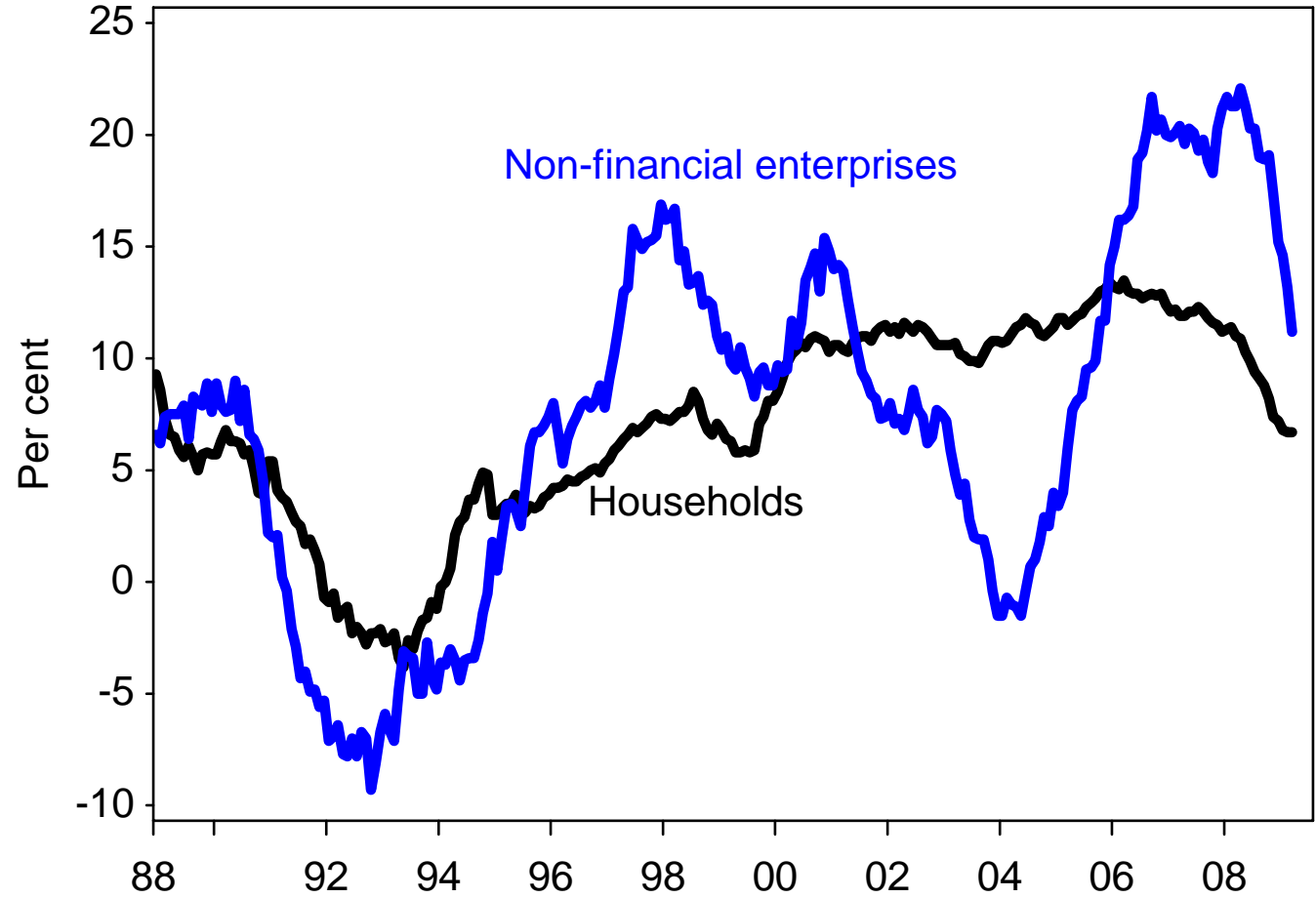


Real prices and nominal prices



Sources: NEF, EFF, ECON Pöyry and Finn.no

Growth in credit to enterprises and households



Banks' loan growth ability in 2009

- Kredittilsynet's enquiry: Norwegian banks of the opinion that solvency and liquidity was sufficient to meet customers' loan demands, and a lending growth of 4-7 per cent.
- Norwegian banks had limited capacity to offer loans to new customers and to larger companies that are no longer able to borrow from international banks, loan syndicates or the bond market.
- It is of vital importance to avoid a credit crunch with adverse effects on the real economy and employment. Norwegian banks are not in a crisis, and the authorities' measures should reflect this. Banks will be negatively affected by a credit crunch.
- Kredittilsynet supported and took part in preparing the Government Finance Fund and suggested measures involving the bond market, supporting the proposed Government Bond Fund.

Norwegian banks – where do they stand?

- Tightening of credit standards should be avoided but banks have to ensure good credit standards to avoid problems ahead.
- Statens finansfond offers two financial instruments. Core tier-1 capital is important for banks' risk bearing capacity and their ability to offer loans. Tier-1 capital in the form of hybrid capital will improve banks' funding and make the transition to normal market conditions easier.
- It is now likely that several banks will use the facilities of the Fund. Access to the Fund will reduce uncertainties in the market and make it easier for banks to raise capital from the market.
- Norwegian banks are well situated to meet challenges ahead. It is most likely that Norway will avoid a banking crisis. However, it cannot be excluded that some banks will run into difficulties in 2009 or 2010, and that structural solutions may be necessary.