FINANSTILSYNET
THE FINANCIAL SUPERVISORY AUTHORITY OF NORWAY

Risk Outlook – June 2021

Summary

Since March 2020, developments in the Norwegian and international economy have been strongly influenced by the Covid-19 pandemic and measures to contain the infection. Industries affected by shutdowns experienced a sharp fall in output and employment. The decline in GDP was of historical magnitude, but more moderate in Norway than in many other countries. Extensive government measures have curbed the decline. The level of activity in the Norwegian economy picked up relatively rapidly in a number of industries, but decreased in the first quarter of 2021.

Vaccination of the population will help to gradually scale down the containment measures, thus triggering increased activity in industries subject to government restrictions. Nevertheless, considerable uncertainty attends the future path of the pandemic and its impact on the real economy. High global vaccination rates are vital to preventing new mutations and disruptions in value chains as a result of shutdowns. However, access to vaccines varies significantly between countries. The long-term protection of vaccines, also against new mutations, also remains uncertain.

The heavy household debt burden and high house prices constitute a material risk for the Norwegian economy. There has been a significant increase in prices in the Norwegian housing market throughout the pandemic, and growth in household lending has picked up. Household debt is growing at a higher rate than income, and the share of households with a high debt-to-income ratio has risen in recent years. Many households will be in a vulnerable position in the event of a substantial interest rate increase, a fall in house prices or declining incomes.

Commercial property prices have increased considerably over many years. High commercial property prices constitute a significant vulnerability that may affect financial stability in Norway. Changes in consumption patterns and other long-term effects of the pandemic may result in reduced demand and impaired values in various parts of the market. Norwegian financial institutions are heavily exposed to commercial real estate.

In the past, Norwegian banks' losses on loans to Norwegian non-financial firms have far exceeded losses on loans to households. An analysis conducted by Finanstilsynet based on accounting data for Norwegian enterprises indicates that enterprises with weak debt servicing capacity hold an increasing share of outstanding debt. The number of bankruptcies declined in 2020, but may increase as the authorities' support measures are discontinued.

Prices of equities and bonds in Norwegian and international financial markets rose rapidly after the market turbulence and sharp fall in prices in March 2020. In 2021, equity prices have reached new all-time highs in many countries. Several stock exchanges are experiencing a historically strong market for initial public offerings, often in special purpose acquisition companies – SPACs. Risk premiums on bank and corporate bonds are now in many cases lower than prior to the pandemic, and valuations are high in several markets.

This trend must be viewed in the light of extensive fiscal and monetary stimulus in many countries, including central banks' bond purchases.

Government finances have deteriorated in a number of countries due to extensive support measures and lower tax revenue. Several countries also have a high corporate debt level. High debt poses a risk to the global economy and the financial system.

Prices of important commodities have risen sharply in the recent period. There are reports of an increasing shortage of input factors, and freight rates have risen. Capacity constraints in key markets and higher inflation may require a tightening of economic policy sooner than expected. Risk premiums may also increase from the current very low level and lead to a sharp fall in prices of equities, bonds and real estate.

Banks experienced a decline in profits and return on equity in 2020, but retained healthy profitability. For 2020 as a whole, recorded loan losses were at the highest level since the banking crisis in the 1990s, but still lower than feared in the early stages of the pandemic. Losses were particularly high on loans to enterprises in the oil and offshore sector, which due to high overcapacity and weak profitability were exposed to loss even before the pandemic. There was also an increase in losses on loans to sectors that were particularly hard hit by the containment measures, such as tourism and food services. However, the banks' overall exposure to these sectors is relatively low. Within retail trade, there was a decline in loan losses and non-performing loans, probably as a result of closed borders. Banks' deposit spreads narrowed in 2020, which was a factor behind the reduction in income from core operations. The decline was particularly sharp for banks that are largely funded by deposits, which in practice are often small banks. Figures for the first quarter of 2021 show higher earnings as a result of lower recorded loan losses.

Norwegian banks' capital adequacy ratios increased in 2020 as a result of retained profits. On the basis of a recommendation from the European Systemic Risk Board (ESRB), the Ministry of Finance has asked Norwegian banks to apply caution in making dividend payments due to the continued high level of uncertainty attending economic developments. The Ministry expressed an expectation that banks will limit total distributions for the financial years 2019 and 2020 to maximum 30 per cent of cumulative annual profits for the two years. In the first half of 2021, banks have kept dividend payments within this limit. At the same time, many banks' Boards of Directors have been authorised to make further distributions in the fourth quarter of 2021.

The market turmoil in the spring of 2020 affected the price of banks' market funding. For a short period, risk premiums were as high as during the financial crisis. Owing to positive market developments following the implementation of extensive fiscal and monetary policy measures, however, risk premiums quickly returned to pre-pandemic levels. Norges Bank has terminated several of its extraordinary liquidity measures.

Finanstilsynet's stress test for 2021 shows that many banks may be strongly affected in the event of a serious setback in the Norwegian economy. In the stress scenario, it is assumed that global supply-side capacity problems and pent-up demand as a result of the shutdown measures lead to rising inflation and higher key policy rates internationally. This also gives an increase in inflation and a higher key policy rate in Norway. Money market rates and risk premiums rise parallel to a sharp fall in securities and property prices. Inflation remains high, and the interest rate level does not decrease until the end of the projection period. This leads to a severe contraction in economic activity and sizeable loan losses. The stress test shows the importance of banks retaining the strong financial position they have built up in recent years.

After several years of strong growth, there has been a reduction in the volume of consumer loans over the past couple of years. This is partly attributable to government measures, including regulation of lending practices and the establishment of debt registers. On the other hand, the quality of banks' consumer loan portfolios has deteriorated sharply, and there was a high proportion of non-performing consumer loans at end-March 2021. This proportion has increased markedly in recent years despite the banks' sale of non-performing loans to debt collection agencies. There is a risk of increased losses on consumer loans in the years ahead.

The containment measures have affected households' financial position in different ways. While some have experienced a loss of income, many have increased their savings due to limited consumption opportunities. Households' financial savings rose considerably from 2019 to 2020. A similar trend has been observed in many other countries. Both in Norway and internationally, a rising number of households invest directly in the stock markets. The increase is particularly strong in the younger age groups. As a result of the increase in equity investments, pension savings and equity fund subscriptions, Norwegian households' equity exposure has doubled since 2015.

Over the past year, a substantial proportion of the listings in the Norwegian market have been carried out by relatively newly established enterprises on the Euronext Growth trading platform, which is an unregulated trading venue linked to Oslo Børs. Such listings may contribute to giving these enterprises easier access to risk capital. However, there is considerable risk associated with investments in startups. Arrangers, the trading venue and other professional players therefore carry a great responsibility to ensure that relevant risks are communicated to potential investors. Investor protection is especially important for consumers, who do not have the same expertise as professional investors to assess investment risk.

Life insurers and pension funds have large securities portfolios and experienced significant fluctuations in returns through 2020. In spite of the fact that equity prices had largely rebounded at year-end 2020 after declining in the spring, there was a reduction in the return on policyholders' funds in the collective portfolios in 2020. At the same time, the financial position of many pension undertakings deteriorated, as the decline in interest rates gives an increase the present value of future liabilities relating to products with guaranteed rates of return. Thus far in 2021, interest rates have risen somewhat again, but the interest rate level remains far below the average guaranteed return. Overall, the undertakings' solvency ratios, according to fully phased-in Solvency II rules, are slightly below pre-pandemic levels.

Non-life insurers are also affected by the Covid-19 pandemic. Financial revenues declined in 2020, but there was a rise in profits from insurance operations. This is partly due to a reduction in car traffic, quick prevention of water and fire damage as people are increasingly present at home and at holiday homes, and reduced travel activity.

Climate change and the transition to a low-emission society entail a significant restructuring of the economy, with financial losses in industries and enterprises that are negatively affected by the changes. This may also inflict losses on financial institutions. Finanstilsynet expects financial institutions to cover all significant risks, including climate risk, in their risk management systems. Several of the banks have included general reflections on sustainability and climate risk in their governing documents. However, the banks have not come very far in assessing climate risk in their loan portfolios. Finanstilsynet will further refine its supervision in this area.

A key function for financial institutions and the securities markets is to allocate capital to sustainable projects. Lack of uniform information about the climate effects of various investment projects and enterprises' exposure to climate risk makes it more difficult to price climate risk correctly in the financial markets, which could result in less efficient capital allocation. In April 2021, the EU published the first technical criteria for defining sustainable activities. The taxonomy does not leave room for national discretion in the implementation and will apply to enterprises and the financial industry throughout the EEA. Over the past year, Finanstilsynet has carried out surveys of how enterprises deal with climate risk and sustainability. Although many enterprises have made strides in this field, the general impression is that this work must be intensified in order to comply with new EU requirements that are expected to be implemented in Norwegian law shortly.

The Covid-19 pandemic has speeded up the digitalisation of financial services. This provides major benefits for users and society, but also creates new vulnerabilities. The scale of cyber attacks is increasing year-on-year, but so far has not resulted in major incidents at institutions in the Norwegian financial sector. However, serious vulnerabilities have been revealed in some institutions. It is important that the institutions are working continuously to strengthen their defences in order to ward off attacks before they have serious consequences.