FINANSTILSYNET
THE FINANCIAL SUPERVISORY
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RISK OUTLOOK
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Risk Outlook

Finanstilsynet analyses and assesses stability in the Norwegian financial system. Its assessments are published in the report *Risk Outlook* twice yearly, in June and December.

SUMMARY

Considerable uncertainty attends future developments in the real economy and the financial markets, both in Norway and internationally. Underlying inflation has remained high and interest rates have risen considerably over a short period of time. Central banks have announced further rate hikes if this is necessary to bring inflation back to set targets. The uncertainty is reinforced by the war in Ukraine and the geopolitical level of tension. Activity remains high in the Norwegian and global economy, but there is a considerable risk of an economic downturn combined with persistently high inflation, so-called stagflation. Such international developments may result in substantial losses and financial market turbulence. This will also affect the Norwegian economy and the Norwegian financial system.

The turbulence in the banking sector in spring 2023, with the collapse of several regional banks in the US and Credit Suisse in Switzerland, shows that crises may occur abruptly and trigger market turmoil. Underlying vulnerabilities could rapidly lead to an outflow of customer deposits and solvency problems in banks, which in turn could affect the financial system, both nationally and internationally. The banking turbulence in the US and Switzerland has had limited consequences for Norwegian financial institutions.

Improved banking supervision and stricter capital requirements in the wake of the financial crisis have contributed to more resilient banks. At the same time, several years of very low interest rates and easy access to credit have resulted in vulnerabilities in the form of debt accumulation and high prices of real estate and other capital assets. This has heightened the risk of financial instability.

There is a close correlation between credit, market and liquidity risk in the financial system. Stricter capital requirements increase the resilience of the banking system and thereby also help reduce the risk of massive withdrawals of customer deposits (bank runs). The scale and speed of the events in the US demonstrate the importance of a well-capitalised banking system.

High debt in Norwegian households and elevated residential and commercial property prices represent the key vulnerabilities in the Norwegian financial system. Since the banking crisis in the early 1990s, house and commercial property prices and household debt have risen sharply. Even though higher collateral values, low interest rates and favourable economic developments have contributed to low loan losses in the years following the banking crisis, Norwegian banks are particularly vulnerable in a scenario characterised by an economic downturn, a sharp rise in interest rates and a property market crash.

The debt burden of Norwegian households is high, both in historical terms and compared with households in other countries. There has been an increase in the proportion of households with a high debt burden in recent years. Over the past year, the twelve-month increase in household debt has edged down. Combined with higher nominal income growth, this has contributed to reducing the debt-to-income ratio, although the ratio remains high. Parallel to this, the interest burden has increased significantly. Only a small proportion of overall household debt carries fixed interest rates. Many households are particularly vulnerable to a further rise in interest rates, loss of income or declining house prices.

Commercial property prices have risen markedly over several years as a result of increasing rental prices and low required rates of return. The banks have a significant loan exposure to commercial property companies. In the past, both Norwegian and international banks have suffered substantial losses on commercial property exposures during crises in the financial and property markets. A strong rise in interest rates and higher risk premiums may lead to a substantial fall in commercial property prices and increased credit risk for the banks. Commercial property companies have large volumes of debt falling due over the next few years and are thus subject to considerable refinancing risk. Finanstilsynet's analyses in connection with a thematic review of selected banks' lending activities in the commercial property market show that many commercial property companies will be severely affected by interest rate increases, lower rental income and reduced property values.

Supervisory authorities in many countries are particularly concerned about the high risk in the commercial property market. The European Systemic Risk Board (ESRB) has issued a recommendation to the competent

authorities in the EEA on the implementation of measures to prevent systemic risk associated with the commercial real estate sector.

On average, Norwegian banks have a high level of profitability and meet regulatory capital and liquidity requirements. The IMF and the European Systemic Risk Board emphasise that there is a high risk of an international economic downturn. In Finanstilsynet's stress test, it is assumed that inflation and policy and market rates will increase further internationally, that global trade and the production of goods and services will decline, and that unemployment will rise. This will have a severe impact on the Norwegian economy and Norwegian banks. Norwegian banking groups' CET1 capital is estimated to decrease from approximately 18 to 12 per cent, primarily as a result of higher loan losses. The capital adequacy ratios of a number of banks will decline substantially. If the countercyclical capital buffer is assumed to be reduced to zero, eleven of the 18 banking groups will not meet the minimum requirement and the buffer requirement for CET1 capital in the stress scenario.

If large losses were to occur and it becomes necessary to draw on capital buffers, experience shows that banks can rapidly lose market confidence and experience liquidity problems. In light of the considerable economic and financial uncertainty, Norwegian banks should seek to meet regulatory requirements by an ample margin, which will help bolster market confidence even in a stressed situation. Finanstilsynet expects Norwegian banks to apply caution with respect to dividend payments and share buybacks. The European Supervisory Authorities have expressed a similar expectation.

Life insurers and pension funds enjoy a strong solvency position. Pension institutions manage extensive capital and may therefore be adversely affected by market turbulence. They may also contribute to market turbulence or fluctuations if they, as a result of investment losses and reduced risk-bearing capacity, have to change their investment profile considerably in a short space of time. The institutions have sizeable investments in the property sector in the form of real estate, property shares, bonds issued by property companies and real estate funds. A sharp fall in commercial property prices, as assumed in Finanstilsynet's stress test of banks, will result in substantial losses and a pronounced weakening of Norwegian life insurers' capital buffers. Finanstilsynet expects the pension institutions' capital planning to factor in the considerable downside risk.

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