FINANSTILSYNET
THE FINANCIAL SUPERVISORY
AUTHORITY OF NORWAY

Risk Outlook – June 2022

Summary

The economies of Norway and several other countries are now characterised by high levels of activity and few available resources. An expansionary fiscal policy, record low interest rates and ample liquidity have contributed to a rapid economic recovery following the sharp downturn in 2020 triggered by the Covid-19 pandemic.

Supply chain disruptions, partly as a result of the Covid-19 pandemic and the war in Ukraine, have dampened growth prospects and contributed to a sharp rise in global inflation. Central banks in several countries have raised their key policy rates and announced further interest rate increases. In addition, central banks that have built up large bond holdings as a monetary policy measure have started to reduce them. Prospects of weaker economic growth combined with persistently high inflation have raised fears of stagflation.

Expectations of monetary policy tightening are reflected in a continued rise in yields on bonds with long maturities since the turn of the year. The same factors have contributed to increased volatility and declining values at several of the world's stock exchanges. The Norwegian stock market is heavily exposed to the energy sector, which has helped raise the stock exchange index. Nevertheless, several sectors show a weak development.

High debt in Norwegian households and elevated property prices still represent the key vulnerabilities in the Norwegian financial system. Households' debt burden is high both in historical terms and compared with other countries, and almost all of the debt carries floating interest rates or has a short fixed-rate period. Many households have very high debt relative to income and the value of their property. These are vulnerable to declining incomes, rising lending rates and falling house prices.

If a large number of households have to reduce their purchases of goods and services at the same time, it could have major negative ripple effects in the economy and the financial system. In such a situation, there is reason to expect substantial losses on banks' corporate loans. Although Norway has a strong creditor protection system and losses on residential mortgages have been low in a historical perspective, there could also be a high level of losses on loans to households.

House prices in Norway have risen considerably over a protracted period, and the price level is significantly higher than prior to the pandemic. The ratio of house prices to households' disposable income is high compared with a number of other countries. The protracted low interest rate level has been a key factor behind the rise in house prices. A sharp rise in interest rates may trigger a substantial fall in house prices.

Household sector investments in equities are limited, but have increased. This applies to both equities held directly and investments in equity funds. A higher exposure to equities makes households more susceptible

to turmoil and falling values in the stock markets.

Commercial property prices in Norway have risen sharply over many years, and the banks have large portfolios of loans to commercial property companies. A strong rise in interest rates or significantly higher risk premiums may lead to a substantial fall in commercial property prices and heightened credit risk for the banks. Increased focus on environmental requirements may cause greater uncertainty about the properties’ market value, especially for older buildings.

The Norwegian business sector is characterised by a high level of activity. However, uncertainty has increased as a result of the war in Ukraine, new shutdowns in China and weaker global growth prospects. Owing to a sharp increase in energy prices, parts of the Norwegian business sector are experiencing a strong improvement in profitability. However, the higher energy prices, coupled with higher input, shipping and inventory costs, contribute to weaker earnings in a number of other firms.

Norwegian non-financial firms have had a high debt burden for many years. With the exception of a few industries, there have nevertheless been a low volume of non-performing loans and losses in the banks’ corporate portfolios in recent years. Higher interest rates and rising cost levels heighten the risk of debt servicing problems in the business sector.

Higher commodity prices have resulted in significant changes in the prices of several types of commodity derivatives. Increased volatility is a factor behind higher margin requirements and may also have led to higher costs associated with derivatives trading. Liquidity problems stemming from much higher margin requirements may have significant ripple effects in the financial system and amplify price fluctuations in the market.

The risk of cybercrime is increasing. During the Covid-19 pandemic and in connection with the war in Ukraine, the key institutions in the financial infrastructure have demonstrated a high level of emergency preparedness. However, the threat picture is constantly changing. Close interconnectedness in the financial system raises the risk that individual incidents will escalate, affect more market players and lead to financial instability.

Norwegian banks enjoy strong profitability, and the banks' loan losses have been low in 2021 and so far in 2022. The banks have generally preserved their solvency levels and meet current capital requirements by a margin. Liquidity reserves and a high proportion of stable funding help reduce banks' liquidity risk. Finanstilsynet expects banks’ capital planning to factor in the considerable uncertainty that prevails about future economic developments. It is vital that the banks are well capitalised to be able to absorb loan losses and provide loans to creditworthy customers during an economic downturn.

In Finanstilsynet's annual stress test of Norwegian banks’ capital adequacy, the global economy is assumed to enter a long period of high inflation, interest rate hikes and lower economic growth. In the stress scenario, it is assumed that supply chain disruptions increase and that there is a steeper rise in prices of energy, other commodities and agricultural products. Corporate earnings are severely affected, and banks' losses on loans to non-financial firms and households rise sharply. There is a steep decline in banks’ capital adequacy ratios. Almost half of the banking groups are in breach of the regulatory requirements for common equity Tier 1 capital during the stress period.

Pension institutions improved their profitability in 2021, but higher interest rates and a decline in the stock market contributed to weaker returns for life insurers in the first quarter of 2022. Sizeable financial market investments make the pension institutions vulnerable to a reduction in prices of equities, bonds and real estate. However, higher interest rates will, over time, be an advantage for pension institutions with a large proportion of pension products with guaranteed rates of return.

Owing to high financial revenues, partly driven by the sale of operations, the combined profits of non-life insurers were sound in the first quarter of 2022. However, there was a certain decline in profits from insurance business. Overall, non-life insurers' solvency ratio remains strong.

Both professional investors and households place greater emphasis on climate considerations than previously in their investment decisions. There are also signs that investors focus more on social inequality and increasingly require issuers of financial instruments to safeguard employees’ rights and take other social considerations into account. The volume of so-called sustainable financial products is growing strongly both in Norway and internationally. In the Norwegian bond market, just over a quarter of issuances made by non-financial firms in 2021 were classified as green. The EU classification system for sustainable economic activity is an important measure to prevent greenwashing and will provide a basis for preparing standards and labelling schemes for green financial products.