FINANSTILSYNET
THE FINANCIAL SUPERVISORY AUTHORITY OF NORWAY

Risk Outlook – June 2020

Summary

The outbreak of covid-19 and measures to limit the spread of the virus caused extensive financial turmoil and a steep decline in economic activity in a number of countries within a short period of time. There was a pronounced fall in oil prices. Norway and several other countries have not experienced a similar decline in production since the 1930s, and unemployment very quickly increased to historically high levels.

In recent weeks, the authorities, both in Norway and in other countries, have gradually reduced their comprehensive infection prevention measures. Businesses have been able to reopen, and many have returned to work. Nevertheless, significant uncertainty attends future economic developments, which will be influenced by factors such as the spread of the virus and government measures to contain infection, the possibility of a vaccine being developed and the duration of behavioural changes triggered by the pandemic.

The corona crisis has already caused a significant loss of income for many individuals and businesses. This is also the case in Norway, although the income loss has largely been borne by the government through its compensation schemes for individuals and businesses. Norway has considerable room for manoeuvre in fiscal policy that can be used to mitigate the economic downturn. Nevertheless, the government cannot be assumed to maintain activity levels and compensate for loss of income in sectors that face lasting production and income losses due to structural changes. Continuing record-low interest rates will make it easier to service loans. In spite of this, many borrowers who experience a lasting shortfall in income will fail to meet their payment obligations.

Although the depth and duration of the crisis are uncertain, it must be taken into account that banks may suffer substantial loan losses in the period ahead when households and businesses do not have sufficient income to service their loans parallel to a fall in collateral values. In the first quarter of 2020, Norwegian banks recorded the highest losses since the banking crisis about 30 years ago.

Norwegian banks are well positioned to absorb higher loan losses. The banks record strong earnings before losses, which represent their first line of defence, and they are well-capitalised after building up equity in the years following the international financial crisis. In order to avoid that the economic setback is reinforced by restraints on borrowing, it is important that banks have enough equity to cope with large loan losses while being able to extend new loans to creditworthy firms and households.

The banks' capital determines their ability to bear risk. Lower capital requirements may contribute to increasing banks' risk appetite and thus their willingness to lend. However, if lower capital requirements prompt dividend payments and other distributions of equity, the banks' ability to provide new loans will be impaired. In light of the high level of uncertainty and the significant loan losses that may arise, it is therefore crucial that the banks retain their equity in the period ahead rather than make distributions in the form of dividends, etc. The capital requirements should not be further reduced unless this is combined with a requirement that banks retain all capital.

The shock that has now hit the economy and the markets is of a different nature than the shocks that have triggered financial crises in the past. While the international financial crisis led to a strong demand-side shock, the world is now also facing supply-side disruptions due to shutdowns and broken supply lines on a scale that has never been seen before. Once again, however, the preceding period has been characterised by strong debt accumulation, increased asset prices and low risk premiums. Government finances are weak in a number of countries, household debt is high, in Norway as well as in certain other countries, and an increasing proportion of corporate debt is taken out by businesses with poor debt servicing capacity.

Global stock markets reacted immediately to the negative outlook. Bank shares were among the most severely affected, including those of Norwegian banks, despite the fact that they were better capitalised and had a stronger liquidity position than prior to the financial crisis in 2008. In the bond markets, the risk premium increased significantly, especially in the high-yield segment. For several enterprises it was, in effect, impossible to raise new debt capital. The market reaction in the first weeks of the crisis was stronger than during the international financial crisis in 2008. However, the decline in securities prices has largely been reversed over the past few weeks.

The corona crisis and the fall in oil prices will probably affect the Norwegian economy for quite some time. As the consequences spread throughout the economy, a growing number of enterprises are likely to experience payment problems. The number of bankruptcies and liquidations will increase in several industries. Banks provide loans to most industries, and the situation will affect Norwegian banks in the form of lower current earnings and higher loan losses. Loans secured by commercial property represent a significant proportion of banks' corporate loan portfolios. For their part, commercial property companies are exposed to tenants in a number of different industries. Some of these, such as hotels and restaurants, are directly affected by temporary restrictions, while shopping centres and some categories of retail trade may be particularly vulnerable in the somewhat longer term. Increased use of e-commerce may also change the need for commercial premises.

A large proportion of enterprises in the oil service, transportation and other shipping sectors recorded negative operating results even before the onset of the crisis. Several of the largest Norwegian banks have a significant loan exposure to these industries. Low oil prices over a protracted period will further weaken earnings in the oil service industry and increase banks' loan losses.

As a result of strong debt growth over many years, households' debt burden was very high at the start of the crisis, and their vulnerability to declining income was equally high. In addition, housing prices have risen sharply, heightening the potential fall if the crisis eventually causes a turnaround in the housing market. Developments in the financial markets have also reduced the value of household savings in securities, both directly and through pension products, as well as the value of non-financial firms' securities portfolios. Although the authorities' extensive measures and a generally well-developed financial safety net will dampen the consequences of the crisis, a number of households may be strongly affected.

There has been a significant shift in the consumer loan market over the last couple of years. At end-March 2020, the volume of consumer loans to Norwegian customers in the institutions included in Finanstilsynet's survey was almost 10 per cent lower than a year earlier. At the same time, the volume of non-performing consumer loans has increased markedly. The income shortfall resulting from the corona crisis increases the risk that vulnerable households have or will take out consumer loans that they will not be able to service. This could result in a heavy personal burden for these borrowers and in significant loan losses and an impaired reputation for the banks.

The largest Norwegian banks have a high level of debt in the international capital markets and are dependent on well-functioning markets. New liquidity requirements and effective government measures help to reduce the refinancing risk, but increased turmoil may lead to higher funding costs and, at worst, difficulties in raising new capital and refinancing maturing debt.

Finanstilsynet's stress test for 2020 is based on the challenges faced by the Norwegian economy in the wake of the pandemic and the fall in oil prices. Two possible scenarios have been worked out based on different assumptions about the progress of the pandemic and the design of measures. In the first scenario, it is assumed that the shutdown of Norwegian businesses largely will be lifted at the start of the third quarter. In the second scenario, the consequences for the Norwegian economy are more serious and last longer. Both scenarios show significant losses for the banks. In the most severe scenario, there is a sharp decline in banks' common equity Tier 1 capital ratios, and a number of banks will not meet the regulatory capital adequacy requirements at the end of the stressed period. Consumer loan banks will be particularly hard hit.

The corona crisis affects the insurance industry in various ways. Lower interest rates and a decline in the value of investments contribute to a weaker solvency ratio. Earnings may also be affected as a result of higher claims payments and lower premium income. The insurance industry as a whole has a strong solvency position. The crisis requires that the solvency capital that has been built up is retained in the undertakings for the time being.

Life insurers and pension funds have large securities holdings and were immediately affected by the market turmoil. The value of their equity portfolios fell sharply and quickly during the first quarter, while higher credit risk premiums gave an immediate reduction in the value of corporate bonds. Several pension funds and insurance undertakings chose to scale back their investment risk, and some pension funds received capital injections to enable them to meet the capital requirement. The weak growth prospects are a factor behind the very low long-term interest rates, which give an increase in the present value of future liabilities and will make it more difficult in the longer term to achieve excess returns for pension funds and life insurers with a large proportion of guaranteed products sold to the private sector.

The market turmoil also caused significant investment losses for non-life insurers during the first quarter of the year. Non-life insurers will also be affected by the corona crisis through increased claims payments in certain lines of business, partly related to travel insurance. In addition, the economic setback may contribute to lower premium income.

The low interest rates heighten the risk that private individuals will be offered savings in more complex products with high underlying risk. Finanstilsynet will focus particular attention on how alternative savings products are marketed in the period ahead.