FINANSTILSYNET
THE FINANCIAL SUPERVISORY
AUTHORITY OF NORWAY

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Summary of the report Financial Trends 2013

Summary and assessments

Much uncertainty attends the international economy which is still marked by financial imbalances. Growth in the industrialised countries appears to be picking up somewhat, but growth estimates for the emerging economies have been revised down. The Norwegian economy continues to fare well despite slower growth and a slight rise in unemployment. Household debt continues to grow faster than incomes, but house prices appear to have levelled off. A weaker development in the world economy will hit the Norwegian economy, in particular if it leads to a substantial and lasting reduction in the oil price, which would adversely affect the Norwegian economy on a broad front. Norwegian banks are well capitalised and profitable but need to further strengthen their capital adequacy to meet higher regulatory requirements. Strong banks are crucial to the Norwegian economy's ability to withstand a potential setback, and the banks are in a good position to increase their equity capital.

ECONOMY AND SECURITIES MARKETS

Growth rates in the world economy slowed towards the end of 2012, and the low growth continued in the first half of 2013. Activity levels in the industrialised world have picked up somewhat while growth in the emerging economies has fallen substantially. Several emerging economies are experiencing scarcer access to funding. Most of the global growth nonetheless continues to be driven by the emerging economies. The industrialised countries remain heavily affected by the reverberations of the financial crisis. Many countries have sizeable budget deficits, substantial debt and high unemployment. Global growth in the current year is expected to be lower than last year. The IMF has revised down its growth forecasts for 2013 and 2014.

Growth in the Norwegian economy has fallen over the past three quarters. Unemployment remains low, but has risen slightly. Domestic demand has contributed to slower growth, and traditional merchandise exports have also been on a weak trend. The period following the international financial crisis has seen increasing evidence of a two-track Norwegian economy. Several export-oriented industries are adversely affected by stagnating markets and impaired competitiveness. Concurrently high oil and gas prices have led to an upswing in petroleum operations and industries that deliver to the petroleum sector. Good income growth, low interest rates and great optimism have fuelled household consumption and housing investments. Household debt continues to grow faster than incomes, but there are signs that the vigorous growth in house prices has come to a halt. Slower economic growth, a weaker labour market and high household debt could dampen the growth in household demand ahead.

Securities market developments are affected by macroeconomic conditions. Market turbulence subsided through 2012 due to strong stimuli from several central banks. Stock markets have risen substantially thus far in 2013, stimulated partly by higher growth in the US and signs of improvement in the euro area. The extent to which the buoyant stock market recovery is ascribable to unprecedented monetary stimulus rather than expectations of stronger fundamentals is not clear. Interest rates remain low despite the slight rise seen in long government bond rates since the beginning of May. The bifurcation of the European bond market between countries with a weak versus a strong government financial position persists, but has become less marked over the course of the year.

RISK FACTORS

Activity levels in the Norwegian economy remain high, and prospects are relatively good, albeit uncertain. However, the risk of a weaker-than-expected trend in the world economy has grown. A sharp setback in the international economy would adversely affect the Norwegian economy, hitting industries exposed to foreign competition that are already struggling with a high cost level and stagnating markets. A weakening of the world economy would in addition heighten the risk of a substantial, lasting fall in the oil price which would adversely affect the petroleum sector and Norwegian businesses that deliver goods and services to petroleum operations. Lower activity levels and earnings in these entities would gradually have substantial negative spillover effects to the wider economy. Weakened corporate earnings would bring unemployment and reduced consumption, which would further intensify the fall in corporate earnings. A marked economic downturn would weaken firms' and households' debt servicing capacity and banks' loan losses would increase.

International interest rates have been very low since the financial crisis in 2008, and are expected to remain low for a long time. This also contributes to very low Norwegian interest rates. High employment, strong income growth and low interest rates have contributed to strong growth in house prices and household debt. Recent months' developments suggest that house prices are levelling off, but household debt continues to grow faster than incomes. A significant portion of the debt is interest-only, and most mortgages carry a variable interest rate. Many households are highly vulnerable in the event of income reduction and/or higher interest rates. Calculations show that an interest rate hike will compel many households to devote a large portion of their income to servicing debt.

Although the turbulence in international financial markets has receded since summer 2012, major imbalances in government finances and uncertainty regarding banks' financial position in many countries which could trigger renewed financial turmoil remain in evidence. New liquidity problems among international banks would feed rapidly through to Norwegian banks, as was seen in autumn 2008.

BANKS

Earnings, financial strength and funding

Norwegian banks have shown sound profits for several years. Low loan losses have been the main contributory factor. Thus far in 2013 losses are somewhat higher than the previous year, but are still at a low level. Banks' net interest revenues relative to total assets have fallen for several years, but rose somewhat in the first half of the current year due to higher lending margins. Growth in lending to corporates has been moderate while growth in lending to households remains high.

Norwegian banks obtain much of their funding in international money and securities markets, and have enjoyed ample access to market funding thus far in 2013. The market situation has been favourable for senior bonds and covered bonds alike. Although the cost of market funding has fallen, funding in the bond market remain costlier than in the period prior to the international financial crisis in 2008. Despite some reduction thus far in 2013, Norwegian banks' market funding remains high. Since market funding largely consists of short-term borrowing from abroad, banks are still vulnerable in the event of a deterioration in market conditions. Their vulnerability is however reduced by recent years' increase in long-term funding, which continued into 2013. Liquidity reserves have also become larger. The largest banks in particular have a high proportion of foreign funding. Smaller banks are also exposed to turbulence in international markets, albeit indirectly.

Banks' common equity (CET1) ratios have strengthened in recent years due to increased equity capital – made possible by sound profit levels and retained profits – and lower growth in risk weighted assets than in total assets. Some banks have also issued new equity. All Norwegian banks met the common equity capital requirement of 9 per cent at the end of the first half-year. Common equity capital relative to unweighted total assets has also risen in recent years, although for banks overall the level is still lower than early in the 2000s. The new capital and buffer requirements introduced on 1 July will be stepped up in the period 2014-2016. Sound profits and a sound trend in the Norwegian economy give the banks a good basis for meeting the higher requirements.

Residential lending practices

House prices and household debt are of key importance for economic and financial stability, for banks' risk and for the individual borrower. The requirement of good debt servicing capacity is crucial for sound credit assessments and is a fundamental requirement of Finanstilsynet's guidelines for prudent mortgage lending practices. It is also highly important that loan-to-value ratios are not excessive, so that banks and borrowers are cushioned in the event of a house price fall. The guidelines accordingly include the norm that the loan-to-value ratio should not exceed 85 per cent of property value. In cases of a higher ratio, either additional collateral must be provided or the bank must have made a particular prudential assessment.

The home mortgage loan survey conducted in autumn 2013 shows that Finanstilsynet's guidelines for prudent residential lending practices are largely embedded in banks' internal guidelines. Although the proportion of new repayment loans with a loan-to-value ratio in excess of 85 per cent is somewhat lower than in the 2012 survey, the figure remains high. When assessing borrowers' debt servicing capacity, the banks add at least 5 percentage points to the current interest rate level, which is in keeping with the guidelines. The volume of interest-only mortgages and the length of the instalment-free period have fallen compared with the previous year. Repayments on home mortgage loans, in particular loans with a high loan-to-value ratio, are important with a view to rendering borrowers less vulnerable in the event of a house price fall.

Strengthening of banks' financial positions to improve robustness

On 14 June 2013 the Storting (Norwegian parliament) passed new legislation on capital requirements for Norwegian banks which went into force on 1 July 2013 and will be gradually stepped up in the period to 2016. The new legislation conforms to the EU's new capital adequacy rules which permits national adjustments grounded in national characteristics and cyclical conditions.

The minimum requirement on common equity capital is set at 4.5 per cent. This is accompanied by a requirement for a capital conservation buffer, a buffer for systemically important institutions and a countercyclical capital buffer. The aggregate requirement on common equity capital is 10 per cent for non-systemically important institutions and 12 per cent for systemically important institutions. In addition the Ministry of Finance may impose a countercyclical capital buffer ranging from 0 to 2.5 per cent. This may be increased in special cases.

The new legislation requires Finanstilsynet to assess all risks to which institutions are and may be exposed, and the risk that institutions represent for the financial system. Finanstilsynet may impose on institutions that do not meet the statutory requirements a capital requirement that is higher than the sum of the minimum requirement and buffer requirements. It can also impose limits on dividends and bonuses, as well as changes in a business activity and its organisation, management and control. In Finanstilsynet's implementation of Pillar 2, account will be taken both of systemic risk developing over time and systemic risk associated with banks' exposures to the same types of risk factors. Account will also be taken of interdependencies in the banking system and of dependence on international financial markets. The assessments will be linked both to minimum requirements and buffer requirements.

Considerable uncertainty attends the extent to which the banks' models reflect relevant risk. This uncertainty is ascribable both to model structure and model parameters. It applies in particular to systemic risk which is difficult to capture in model estimates. Minimum requirements on model parameters need to be incorporated to increase the system's robustness.

On 13 October 2013 the Ministry of Finance amended the rules governing risk-weighted assets for capital requirements for banks that use internal models. To support financial stability the minimum requirement on loss given default (LGD) was raised from 10 to 20 per cent. Under CRD IV, yet to be incorporated in the EEA agreement, this requirement will also apply to foreign banks' branches. In addition, the present Basel I floor will be maintained. Finanstilsynet is now reviewing the banks' models with a view to raising the lowest default probabilities available to banks in their risk models. Finanstilsynet is also reviewing banks' models for estimating LGD.

Finanstilsynet expects the banks, under normal conditions, to maintain capital ratios above the regulatory requirements. Robust, well capitalised banks are crucial to financial stability and also provide banks with competitive strength.

Robust funding and covered bonds
Covered bonds have put Norwegian banks' market funding on a more stable footing. However, there is a risk that heavy dependence on covered bonds may intensify a credit contraction in bad times. There is also a danger that relatively favourable funding available through covered bonds could intensify credit and house price growth in good times. Finanstilsynet requires the banks to maintain a proactive stance on risk posed by asset encumbrance and to consider what level of fund transfers to covered-bond-issuing mortgage companies they regard as prudent. As part of its follow-up on the banks assessments, Finanstilsynet is now ascertaining banking groups' unutilised potential for loan transfers to mortgage companies. It is also looking into the margin by which the cover pool maintained by mortgage companies exceeds statutory requirements and minimum requirements set by credit rating agencies.

LIFE INSURERS AND PENSION FUNDS

Life insurers and pension funds (pension institutions) invest in the securities and property markets. These markets are of great significance for the return on pension institutions' assets. The low interest rate level poses a major challenge to these institutions since insurance contracts include rate-of-return guarantees. In contrast to current legislation, the guarantee commitments under the new European solvency requirements (Solvency II) will be recognised at market value. The new requirements will bring the challenges posed by low interest rates, and the limited opportunities to match the maturity of guaranteed commitments and investments, into greater relief. Work is in progress at the European level to assess various modifications of the Solvency II regulation with a view to reducing the fluctuations in pension institutions' capital and capital requirements.

A sound financial position is crucial if pension institutions are to maintain sufficient risk-bearing capacity to invest in securities that provide satisfactory return over time, while at the same time managing the risk posed by such investments. Pension institutions are compliant with the current capital requirements, but a number of them are likely to encounter problems in fulfilling the capital requirements under Solvency II.

The increase in the number of defined contribution pension plans, mainly unit linked, at Norwegian life insurers entails the transfer of rate-of-return risk from insurers to their policyholders. However, for the insurers, conversion from defined-benefit to defined-contribution pensions also entails closure of pension plans and issuance of paid-up policies. The increased capital requirements on paid-up policies that are expected under Solvency II pose a particular challenge to life insurers. Finanstilsynet has proposed adjustments to the rules governing paid-up policies to partially remedy the situation.

The consequences of the new mortality tables, which take account of the population's increased longevity, pose a further challenge to pension institutions. These are to apply from 2014 and will require insurers to increase their technical provisions. A number of pension institutions have devoted their surplus return in 2011 and 2012 to increasing their technical reserves related to rising longevity, but a further increase in reserves is much needed.

CONSUMER PROTECTION

Consumer protection is an important aspect of the rules developed for the financial market and of the supervision of financial services providers. Well capitalised, liquid financial institutions – a key goal of supervision – are also a prerequisite for good consumer protection. This consideration does not conflict with regulatory development and supervision designed to protect the interests of consumers that purchase financial services.

Finanstilsynet has in 2013 drafted rules designed to improve and widen the documentation obligation on advisers on and vendors of alternative savings products, including sound recordings of telephone conversations. Rules of this type will strengthen consumer protection and harmonise the rules regulating financial instruments and alternative savings products. These products are primarily deposit-based products and unit-linked life insurance.

Following Finanstilsynet's autumn 2012 thematic survey of 24 entities' issuance and invoicing of credit cards, guidelines were in 2013 drawn up for invoicing of credit cards. The guidelines are designed to enable better protection of consumer interests. Requirements are made of the information to be provided, and customers are entitled to request invoicing of overall outstanding credit, which provides a better overview of the costs of various payment solutions.

Effective as from 1 January 2014, amendments have been adopted to the rules of the estate agency regulations with regard to bidding. The key change is that bidding rounds must be documented by requiring communication during the bidding process to take place in writing, and that bidders must provide proof of identity.

The European Commission has presented a series of Directive proposals designed to strengthen consumer protection in the financial sphere. They include changes to the Payment Services Directive (in Norway incorporated in the Financial Contracts Act), a new Directive on mortgage credit, a Directive on key disclosures required of vendors of complicated financial products and rules on advice and information regarding insurance, bank and securities products. The European Union's financial supervisory authorities have drafted guidelines for insurers', banks' and investment firms' internal complaints handling and statements on what are to be regarded as good home mortgage lending practices for banks and for situations where the borrower encounters payment problems.

Press release 23/2013:
Good results at Norwegian banks a sound basis for improved solidity