The Financial Market in Norway 2002: Risk Outlook

THE FINANCIAL MARKET IN NORWAY 2002: RISK OUTLOOK 1

0. INTRODUCTION 5

SUMMARY 5

1. ECONOMIC CONDITIONS AND MARKETS 9

2. TRENDS IN FINANCIAL INSTITUTIONS 13

FINANCIAL MARKET STRUCTURE 13
BANKS 15
COMPETITION AND MARGINS 18
LIFE INSURANCE COMPANIES 18
NON-LIFE INSURANCE COMPANIES 20

3. RISK AREAS 22

CREDIT RISK 22
CREDIT GROWTH 22
HOUSEHOLDS 23
Home mortgage loans 24
ENTERPRISE SECTOR 25
Exposure to selected industries 26
Loans secured by financial instruments 26
Finance Credit 27
BANK LOSSES 27
MARKET RISK 28
BANKS 29
LIFE INSURANCE COMPANIES 29
Life insurance companies' buffer capital 30
NON-LIFE INSURANCE COMPANIES 31
INSURANCE RISK 31
LIQUIDITY RISK 32
Surveys of bank liquidity 33
OPERATIONAL RISK 34
IS THERE A DANGER OF A NEW BANKING CRISIS? 34

Unless otherwise stated, Kredittilsynet is the source of graphs and tables.

The cut-off date for the Norwegian publication was 19 February 2003. This is an abridged version of the Norwegian report.

0. Introduction

Since 1994 Kredittilsynet has systematically analysed and assessed potential stability problems in the Norwegian financial market in light of developments in the Norwegian and international economy. This is a necessary supplement to Kredittilsynet's ongoing supervision of individual institutions, since major parts of the assessment of individual institutions' profitability and financial strength need to be carried out against the background of the general state of the financial market. As from 2003 Kredittilsynet will each year be publishing its view of the state of the financial market and of the various categories of institutions.

Summary

The incipient recovery of the world economy observed in the first half of 2002 came to a halt, entailing a substantial downward adjustment of growth for the full year. Concurrently the timing of an expected renewed upturn has been postponed and a recovery is now expected towards the end of 2003 at the earliest. The outlook for the international economy has become increasingly uncertain recently: whereas the risk picture was fairly balanced half a year ago, negative developments in several regions along with the Iraq situation now suggest lower-than-expected growth ahead. Any new recovery depends in the first instance on developments in the United States.

Share markets have shown a significant decline and much volatility in recent years, reflecting uncertainty following several dramatic events. A substantial fall in international share markets in the summer of 2002 was followed by some recovery both in US and European share markets from early October onwards. Thus far in 2003 the major international markets have again fallen. The Norwegian market has recently shown a weaker upturn and fallen further than foreign markets. The share market trend is reflected in long interest rates which showed a substantial decline during 2002.

Growth in the Norwegian economy was moderate in the first three quarters of 2002, primarily due to a weak trend in investment and exports, while the most important growth components were private and public consumption. The economy is affected by increasingly divergent trends for households and enterprises with households on a positive income trend while enterprises' earnings are under pressure. The weaker economic growth since 2001 has led to declining pressures in the labour market and a moderate increase in unemployment through 2002. This continued into 2003, and higher unemployment can be expected ahead.

While the banks achieved sound profits during the cyclical upturn, a weaker economic climate, share market falls and higher loan losses brought some reduction in pre-tax profits in 2001. This trend continued in 2002, when bank results showed a marked decline on 2001. Not since the early 1990s have the banks posted a weaker overall performance. Despite weaker results, banks have maintained their core capital adequacy thanks to lower lending growth and fresh capital. Although appreciably higher than in 2001, banks' loss provisioning remains low in relation to overall lending.

Banks' credit risk increased in 2002. Gross household indebtedness has risen appreciably in the past four years, and the growth in credit to the household sector is related to the steep rise in housing prices. Households with a heavy debt burden account for a growing share of the sector's overall debt. The bulk of bank loans to households are secured on residential property. According to Kredittilsynet's home loan survey for 2002, the loan-to-value ratio was in excess of 80 per cent in the case of one in three disbursed home loans. However, the rate of defaults is so far relatively low. An increase in unemployment combined with a turnaround in the housing market would give rise to problems for vulnerable households. Although bank losses on home loans are historically speaking low, the indirect impact on commerce and industry can be substantial. Should households reduce their consumption, service trades will be affected.

Enterprises have also substantially increased their borrowing in recent years, and the debt burden for mainland (non-oil) enterprises is now at the same level as at the end of the 1980s. Manufacturing industry's competitiveness has weakened, and a high rate of closures can be expected ahead. The problems facing some sections of the sheltered sector, and ripple effects to the real estate sector, have concurrently increased the vulnerability of the enterprise sector as a whole. Kredittilsynet's survey of banks' exposure to certain industries (shipping, shipbuilding, offshore, oil and gas extraction, fish farming and property management) showed an increase in the section of the portfolio described by the banks themselves as high-risk.

Norwegian banks as a whole have little direct exposure to market risk via holdings of shares and other securities. However, some banks offer loans to households and enterprises to finance securities purchases where the collateral is the securities in question. Kredittilsynet has surveyed banks' practice in this area for several years. While the overall scale of such lending is small, it entails a degree of credit risk in the case of the most exposed banks. Although some banks incurred higher loss on loans secured by financial instruments in 2002, such losses were low for the banking sector as a whole.

Banks' liquidity risk also rose somewhat in 2002. Steep lending growth over several years combined with slower growth in deposits led to a funding gap that was largely covered by way of the money and capital markets. In 2002 lower lending growth combined with higher deposit growth in the wake of the share market slump served to stabilise the situation somewhat. Banks have increased their long-term funding since the mid-1990s. Short-term funding has shown a somewhat flatter trend overall, but remains at a high level. In the case of some banks, short-term funding, including funding via the certificate market, has been substantial.

Weaker economic conditions and falling share markets exacerbated Norwegian banks' position somewhat in 2020. Moreover, a sharper divide emerged between different types of banks. Whereas the three largest banks appear to be in a satisfactory position of rising capital ratios, several small and medium-size banks encountered problems in 2002. Nineteen banks reported accounting losses. While lending by the banks as a whole slowed in 2002, many were still expanding strongly. Several banks saw their core capital adequacy diminish in 2002, although levels at many small banks remained high. There were clear signs of liquidity problems at some small and medium-size banks with substantial short-term funding and weak results caused by losses incurred on individual commitments or weak financial positions. Kredittilsynet carried out a survey of large and medium-size banks' systems for management and control of liquidity risk in 2002 and, towards year-end, a survey of the liquidity position at a selection of exposed banks. Last year saw signs of a more discriminating approach by the market based on criteria such as funding structure, equity capital and organisation of operations. Amply capitalised banks are in general less exposed to liquidity problems. The liquidity situation was somewhat better at the start of 2003 than at the end of 2002.

Kredittilsynet has for several years drawn attention to the challenges pertaining to rapid credit growth, both for the financial market as a whole and for rapidly expanding banks. It has particularly stressed the risk of rapid growth in lending to the enterprise segment. The collapse of the Finance Credit system in 2002 (see also p. 27) highlighted the significance of correct information on ownership structure, accounts and other factors when entering into loan commitments. Although the banks that had extended loans to Finance Credit were clearly misled by flawed accounts, they do not appear to have conducted a sufficiently thorough and detailed assessment of the information available to them. Several banks appear to have substantial room for improvement in terms of monitoring commitments and checking the assumptions underlying their loan disbursements.

Investment firms and management companies for securities funds saw a substantial reduction in earnings due to falling share markets. Thanks to flexible remuneration regimes, few were compelled to close down. However, lower earnings could give rise to consolidation in the form of mergers and closures.

Recent years' fall in share markets has substantially weakened results in the insurance sector. Due to ownership constellations at some financial conglomerates, negative results in the insurance arms of these conglomerates spread to their banking subsidiaries, thereby reducing the earnings of the banks in question. Life insurance companies' value-adjusted result was negative both in 2000 and 2001, and despite share disinvestment this segment incurred another negative result overall in 2002. Non-life insurance companies also recorded a loss on ordinary operations in 2002. A large number of insurance companies remained in a deficit position.

Despite portfolio reinvestments designed to reduce market risk, life insurance companies' situation is unsatisfactory. Crucially, life insurance companies' ability to bear risk has diminished sharply, prompting them to adjust their risk exposure accordingly. Although reduced share exposure lessens these companies' vulnerability to further share market falls, it could take them some time to build up the sound buffer capital position needed to restore their risk-bearing capacity. Life insurance companies can point to appreciably improved capital adequacy in formal terms, but their low buffer capital sets clear-cut limits to the risk they can incur on their investments.

Life insurance companies have taken steps that suggest some improvement ahead. Steep premium increases have improved their technical result in recent years, and asset reallocation has reduced market risk. However, insurance companies' results have become relatively more dependent on interest rate developments ahead.

Economic developments in Norway and elsewhere in the period ahead are marked by substantial downside risk. Although most forecasts suggest a renewed upturn towards the end of 2003, and that the effects of a war against Iraq will be limited, a deterioration of the situation cannot be ruled out. War could exacerbate the medium-term prospects by impairing the international cooperative climate. A wide-ranging economic setback in Norway is unlikely, even though parts of the exposed sector are facing hard times, and regional problems cannot be ruled out. The Norwegian authorities have significant room for manoeuvre should a negative situation arise. The banks that make up the bulk of Norway's banking sector face little risk of problems in the year ahead. However, several small and medium-size banks will face major challenges, above all if the economy proves weaker than forecast. This applies to recent start-ups and banks that have expanded rapidly. But it applies above all to banks with weak operations, poor management and control systems, high liquidity risk and one-sided exposure to credit risk.

1. Economic conditions and markets

The international economy steadily deteriorated in 2002, the main causes being uncertainty surrounding the situation in Iraq, the lasting fall in share markets and sluggish investment activity across the OECD area. While most forecasting institutes project quickening growth towards the end of 2003 or early 2004, they are revising their growth projection down to reflect the weakening trend in 2002.

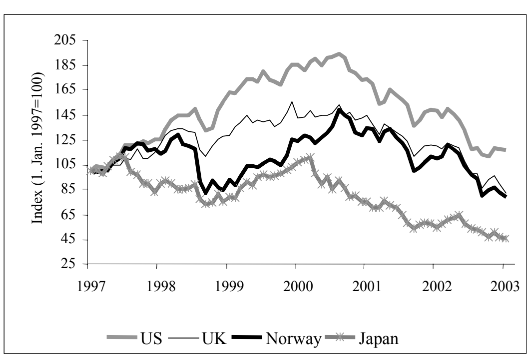
Table 1.1 Growth forecasts

	US		Euro area		Japan		Norway	
	2002	2003	2002	2003	2002	2003	2002	2003
GDP	2.4	2.7	0.8	1.4	-0.3	0.4	1.1	0.8
Inflation	1.6	2.2	2.2	1.7	-0.9	-0.8	1.2	3.1
Unemployment	5.8	6.0	8.4	8.6	5.4	5.7	3.9	4.4

Sources: Consensus Forecasts, January 13, 2003; Economic Survey 6/2002, Statistics Norway

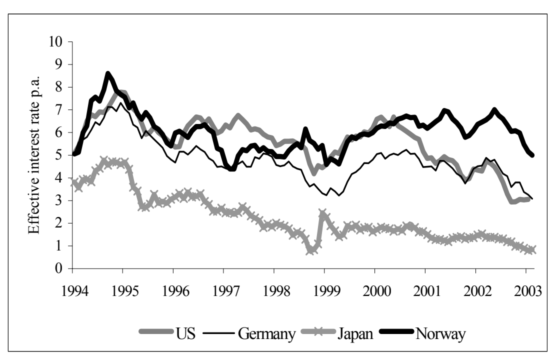
International share markets have declined in the last three years. In 2002 the broad US and UK reference indices fell by about 24 per cent, and the German market by 44 per cent. Despite the US central bank's substantial interest rate cuts from 2001 onwards, investors appear to be wary of the share market. Fixed income markets, to which investors have turned, have also been affected by nervousness. This, alongside lower inflationary expectations, has led to very low long interest rates, particularly in the US. Short rates have also fallen in step with repeated cuts in central banks' key rates.

Chart 1.1: Share markets



Source: EcoWin

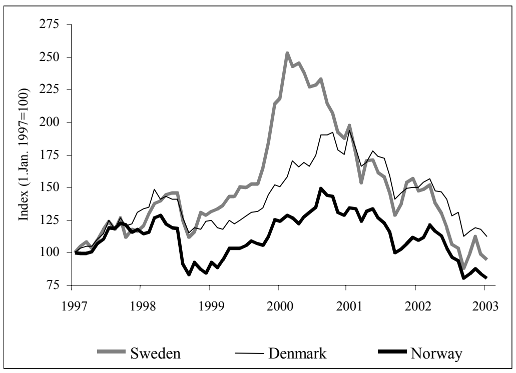
Chart 1.2: Long interest rates



Source: EcoWin

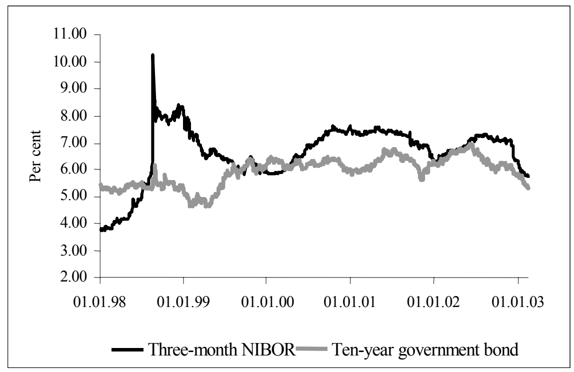
Oslo Børs (the Oslo Stock Exchange) has shadowed the international share market decline, falling 31 per cent in 2002. The other Nordic countries are also heavily affected by the negative trend. Sweden and Finland in particular were hard hit when the high-tech market bubble burst in 2000. Tight Norwegian monetary policy for much of 2002 resulted in a large interest rate differential between Norway and other countries, which narrowed in December and January. High return on Norwegian krone investments also pushed down long rates since this type of investment was increasingly attractive to foreign investors.

Chart 1.3: Nordic share markets



Source: EcoWin

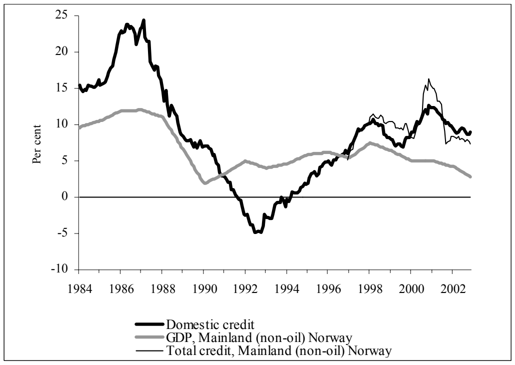
Chart 1.4: The Norwegian fixed income market



Source: EcoWin

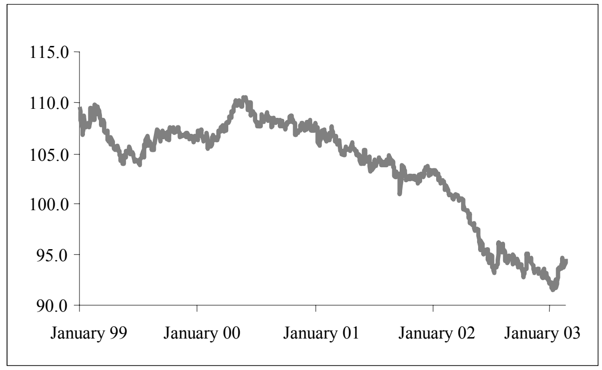
The Norwegian economy is in a slowdown. A weaker international economy along with a period of high real interest rates, strong krone and high wage growth all served to maintain this situation in 2002. Unemployment rose in several sectors, at the same time as profitability in the exposed sector dropped sharply over the year. The krone appreciated by about 10 per cent against the euro, and by more than 23 per cent against the dollar. The decline in the high-tech market meant that businesses in the sheltered sector, especially in the media and consultancy market, were also hit. Concurrently a number of local authorities encountered problems, partly as a result of pay increases: wage growth in 2002 looks set to be about 5.5 per cent. Consumer prices rose by 1.3 per cent from 2001 to 2002, but by 2.3 per cent when adjusted for excise duties and energy. For the household sector tax reliefs, low inflation and an ample wage settlement produced almost 4.5 per cent growth in real income in 2002. Consumption is set to grow by about 3 per cent, suggesting that households are increasing their saving rate.

Chart 1.5: Growth in GDP and credit



Sources: Statistics Norway and Norges Bank

Chart 1.6: Krone exchange rate. Index



Source: EcoWin

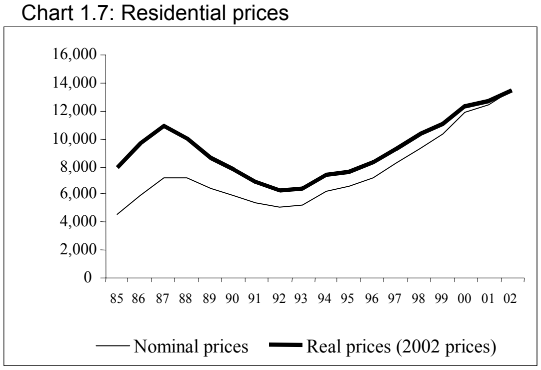
Norges Bank's monetary policy brought high interest rates in 2002. This, together with central government's sizeable financial surpluses, gives the authorities substantial room for manoeuvre in the monetary and fiscal policy to countervail any serious setback and rise in unemployment. In the period around the end of 2002 and the start of 2003 Norges Bank lowered its key rates twice by a total of 1 percentage point. Market interest rates have fallen by at least the same margin.

The Norwegian economy is currently affected by great uncertainty. Pressures in parts of the economy together with high domestic interest rates have widened the interest rate differential between Norway and other countries. This, together with a high oil price, brought a substantial appreciation of the krone. The strong domestic currency is a challenge to competitively exposed businesses which have seen substantial erosion of their profitability. Unemployment in manufacturing rose sharply in January, and for regions and households that are dependent on exposed industries the situation ahead could be problematic. Concurrently recent years' record-high wage growth, combined with over-establishment in some industries in the 1990s, has caused problems in parts of the sheltered sector where employment intensity is high. Consultancy businesses, the ICT sector and media industry have all reduced staff lately, and this in turn affected demand for commercial property in 2002.

Viewed in light of the moderate growth in the real economy, growth in credit to households, enterprises and municipalities remains high. Annual growth in credit from domestic sources (C2) was 8.9 per cent at the end of 2002. Whereas corporate borrowing started to edge down in autumn 2002, growth in credit to households has been stable at about 10-11 per cent over the past two-and-a-half years. In December growth in credit to households stood at 10.6 per cent. Banks' lending growth was at 8 per cent in the same month. Annual growth in overall credit (C3), including credit from abroad, was 7 per cent in November, while overall credit growth (C3) to Mainland (non-oil) Norway was 7.3 per cent.

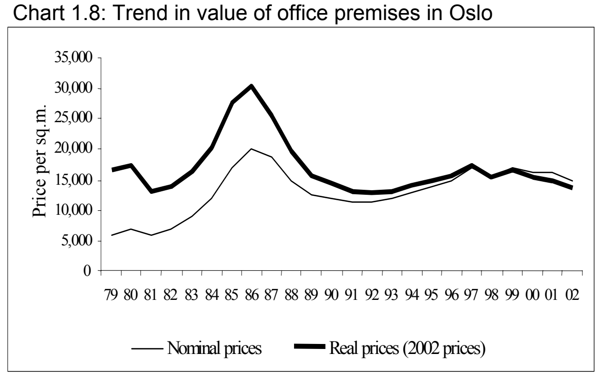
The steep growth in credit to households is related to many years of steeply rising housing prices. Data from estate agencies indicate that housing prices rose by about 8 per cent in 2002, although a flatter tendency was noted in the autumn. Compared with the peak year 1987, prices in January 2003 were 87 per cent higher in nominal terms and 22 per cent higher in real terms. Positive growth in household incomes contributed to this trend, probably along with increased urbanisation, a higher share of one-person households and greater emphasis on a good housing standard. These factors, together with continued good household incomes, suggest a stable housing market ahead. However, since the rising unemployment may add to employed persons' uncertainty about the future, a negative turnaround in parts of the market cannot be ruled out.

Chart 1.7: Residential prices



Sources: NEF/ECON

Chart 1.8: Trend in value of office premises in Oslo



Sources: OPAK and Kredittilsynet

The market for commercial property seems to have reversed between 2001 and 2002, and currently appears weak. Greater availability combined with low demand suggests a poor outlook for the market for office premises ahead.

Office building values were weak in the first half of 2002 after a virtually flat trend in the last couple of years. Prices of office buildings in Oslo are now significantly lower than they were in the mid-1980s. Nominal prices are about 25 per cent lower, whereas real prices have fallen by 55 per cent from their peak at the end of the 1980s. Rental prices in the various segments of the office market fell in 2002, and the number of vacant office premises is growing steadily. The office market in Oslo has been affected by structural changes in the ICT industry, with the result that more unutilised office space is being sub-let. Although rental prices can be expected to continue their downward trend, the potential drop is shorter than it was in the 1980s.

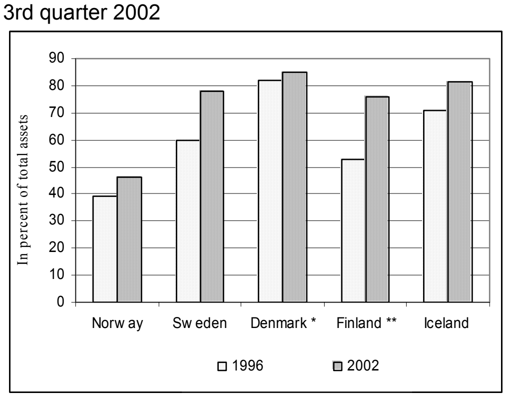
2. Trends in financial institutions

Weaker economic conditions and falling share markets have affected banks and insurance companies in recent years. This chapter starts by briefly reviewing central features of the Norwegian financial market.

Financial market structure

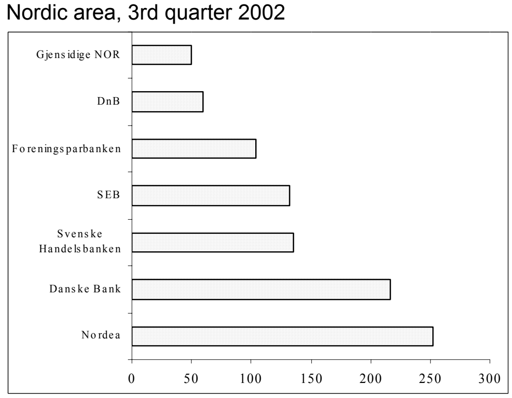
Structural developments in the Nordic banking sectors show significant similarities: over the past decade banks have fallen in number, large institutions have merged and Nordic banks have entered each others' markets by setting up branches or by taking over existing institutions. While concentration in the Nordic credit market has risen between 1996 and 2002, it is far less prominent in Norway than in the other Nordic countries. Norwegian financial conglomerates are relatively small compared to their largest counterparts in Sweden and Denmark.

Chart 2.1: Market concentration* in Nordic credit markets, 3rd quarter 2002



*Market share of the four largest credit institutions
**Denmark: the five largest, Finland: the three largest
Source: Nordic supervisory authorities

Chart 2.2: The largest financial conglomerates in the Nordic area, 3rd quarter 2002



Total assets in billions of EUR
Source: Nordic supervisory authorities

Two important developments have marked the Norwegian financial market since the banking crisis: the emergence of large financial conglomerates and alliances, and the growth of foreign influence via acquisitions and increased establishment of foreign branches. The five major financial conglomerates hold a dominant position in the Norwegian financial market. The conglomerates' highest market shares are in the securities fund, life insurance and banking segments.

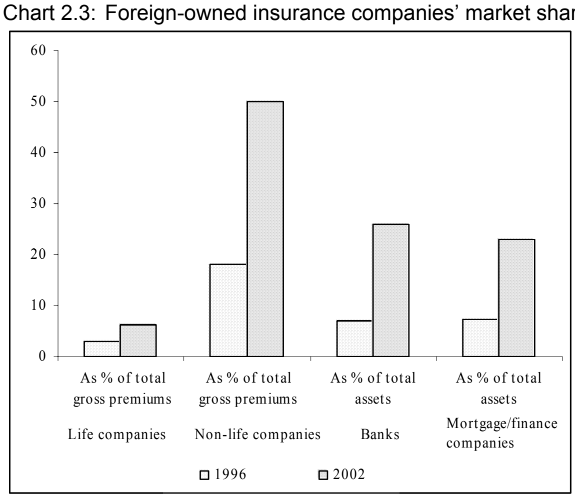
Table 2.1: Market shares of financial conglomerates in various segments. (Total assets (TA) at end-2002)

Per cent of TA	Banks	Finance/mortgage companies	Securities funds	Life insurance	Non-life insurance	Total conglomerates**
DnB	23.1	5.0	24.2	17.4	0.0	18.7
Gjensidie NOR	15.0	11.5	20.1	15.9	24.3	15.2
Nordea	14.3	7.2	9.2	5.8	0.0	11.1
SpareBank1/Collab. savings banks	14.1	1.3	7.4	2.7	4.3	9.7
Storebrand	1.8	0.0	10.8	26.1	0.7	5.9
Total fin. conglo.	68.3	25.0	71.5	68.0	29.2	60.7
Total market	100.0	100.0	100.0	100.0	100.0	100.0

* KLP has a 26.5 per cent share of the life insurance market in Norway.
** "Total conglomerates" equals the aggregate total assets in the various industries and diverges from the conglomerates' own consolidated accounts.

Foreign influence in the Norwegian financial market has risen across all industries (Chart 2.3), particularly in the non-life insurance market. Foreign influence in the Norwegian banking market has risen substantially in recent years due to Nordic banks' acquisition of two larger Norwegian commercial banks. Moreover, several branches of foreign banks are undergoing expansion.

Chart 2.3: Foreign-owned insurance companies' market shares



Banks

Banks' results weakened significantly in 2002 due to higher loan losses and weak share markets. This was the second consecutive year of impaired results, and bank earnings were at their lowest level since 1992.

The number of banks running deficits rose appreciably in 2002. Since the majority were small banks, the deficit banks' aggregate total assets were only marginally higher than the previous year. Both the three largest banks (DnB, Union Bank of Norway / Gjensidige NOR and Nordea Bank Norway) and the category of 128 other savings banks showed a clear decline in pre-tax profit in 2002. After two weak years the category of 13 other commercial banks showed a further decline, reporting a negative overall result in 2002.

Chart 2.4: Result before tax, and losses on loans and guarantees (as per cent of average total assets)

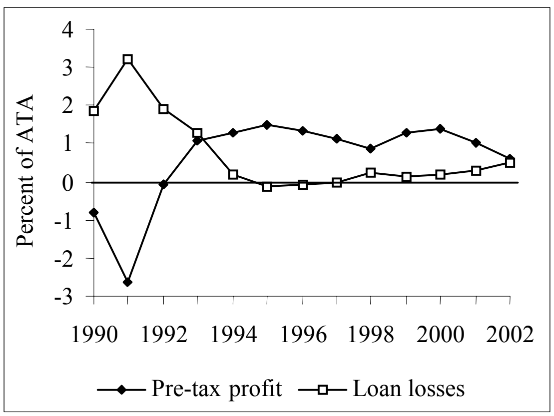
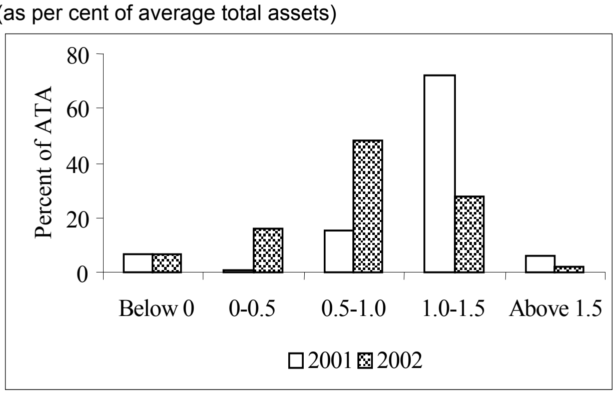


Chart 2.5: Share of banks with results in various intervals (as per cent of average total assets)



The three largest banks achieved far lower return on equity in 2002 than in the previous year. This is partly because the two largest commercial banks incurred very low tax charges in 1991 after a ruling in their favour in a case brought against the tax authorities. Even so, this bank category recorded higher return than the others.

Chart 2.6: Result before tax (Per cent of total assets)

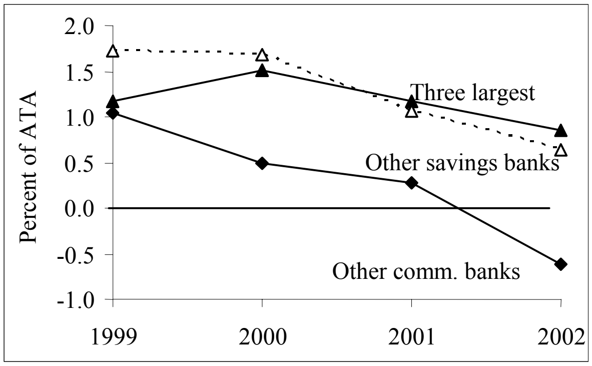
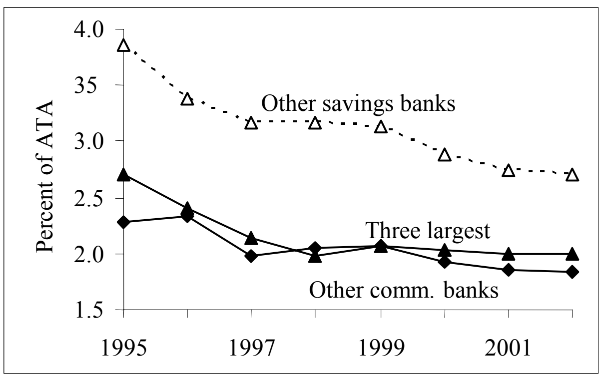


Chart 2.7: Net increase income (Per cent of total assets)



Banks’ main earnings source is net interest income (interest income less interest expenses). Because of the decline in other income, due to a sluggish share market in 2002, net interest income measured more than three-quarters of total operating income in 2002. Banks’ net interest income has been under pressure for several years due to increased competition (Chart 2.7). Thanks to the banks’ focus on rationalisation and efficiency improvements, costs grew considerably less than volume.

After several years of low loan default volumes, defaults rose in 2002 to their highest level since 1996. Banks’ loan losses have also been at a low level overall. However, in the past two years losses have tended to rise, initially among individual banks, then across the industry as a whole. A weaker trend in the exposed sector, reflected in a rising number of business failures, has fuelled the rise in bank losses.

Losses among the three largest banks remain low despite a marked increase in 2002. In the case of the other two categories losses have risen substantially, with the highest loss reported by the commercial banks. A number of savings and commercial banks’ sizeable losses on commitments with the Finance Credit system in the fourth quarter of 2002 made a further contribution to the high losses recorded in 2002.

Chart 2.8: Total bank non-performing loans (as per cent of gross loans)

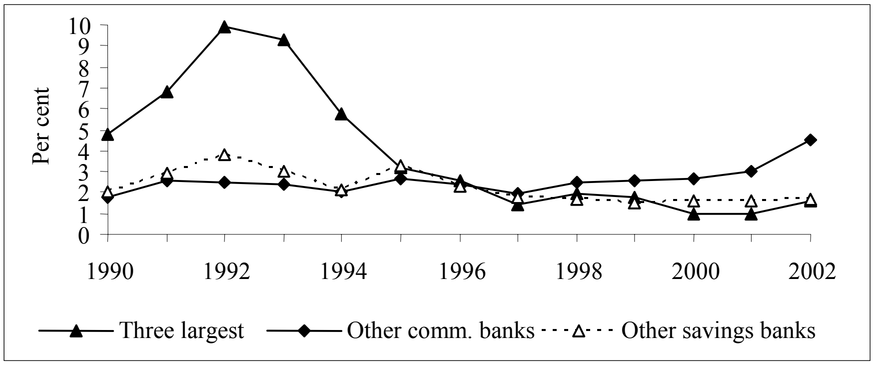


Chart 2.9: Loan losses (as per cent of gross loans)

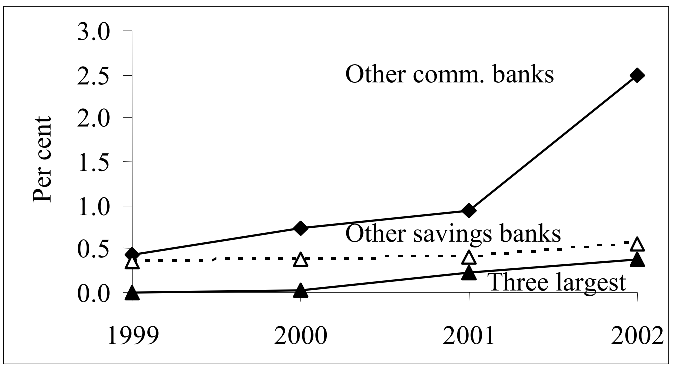
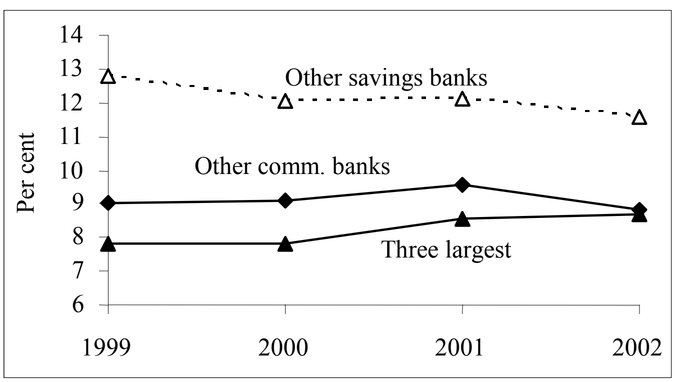


Chart 2.10: Core capital adequacy (as per cent of calculation base)



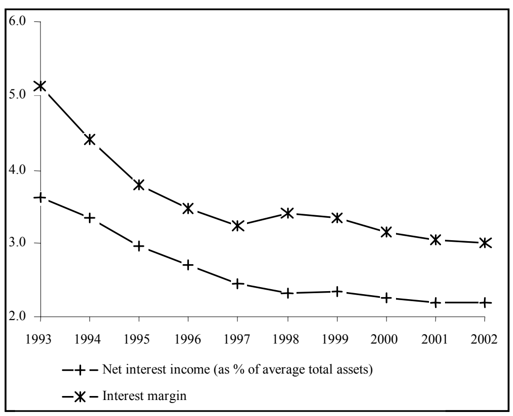
Despite a weaker trend in results, banks' capital adequacy remains fairly sound overall. The three largest banks raised their core capital ratios from 8.5 to 8.7 per cent – the highest ever recorded for this group. For some medium-size and small banks the weak results, in many cases combined with rapid lending growth, have resulted in capital adequacy ratios below 8 per cent. In the current uncertain macroeconomic situation a capital injection to these banks is advisable, possibly accompanied by a balance sheet reduction, to improve capital ratios.

Bank lending growth slowed in 2002. Even so growth recorded by savings banks remained high, close to 10 per cent, indeed higher than the rate of growth in the economy. Growth in the largest banks was moderate, partly due to the effect of a stronger krone in 2002 which reduced the krone value of loans denominated in foreign currency.

Competition and margins

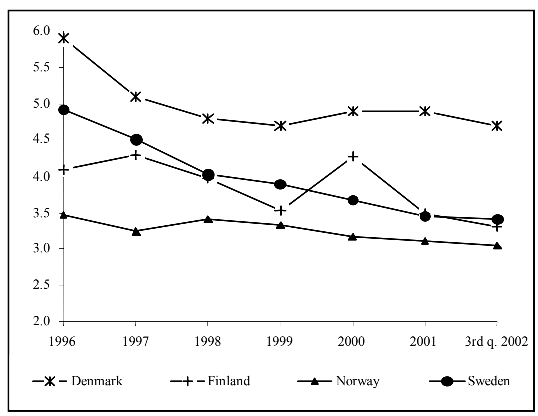
Multinational establishments are a more prominent feature of the Nordic financial area than of the rest of Europe. Competition in financial markets is intense. Norwegian banks' interest margins have fallen since the start of the 1990s, bringing a reduction net interest income in terms of total assets since 1993. Norwegian banks' interest margins in 2002 were lower than those of banks in Sweden, Finland and Denmark. A likely reason is that a larger share of Norwegian bank loans are mortgages secured on residential property.

Chart 2.11: Norwegian banks' interest margins and net interest income



Sources: Norges Bank and Kredittilsynet

Chart 2.12: Interest margins in the Nordic area



Source: Nordic supervisory authorities

Life insurance companies

Life insurance companies' results have been heavily affected by the negative share market trend in the past three years. Value-adjusted return was 1.9 per cent in 2002 compared with 1.1 per cent in 2001. The result before new supplementary provisions, allocation to customers and taxes was a negative NOK 2.2 billion in 2002, a deterioration of NOK 3.1 billion on the previous year. The improvement is in part due to higher price-independent incomes as a result of life insurance companies' reallocation of assets from shares to bonds in the period. The value-adjusted result, including changes in fluctuation reserves, was a negative NOK 3.2 billion.

Chart 2.13: Trend in life insurance companies' average return on capital 1994–2002

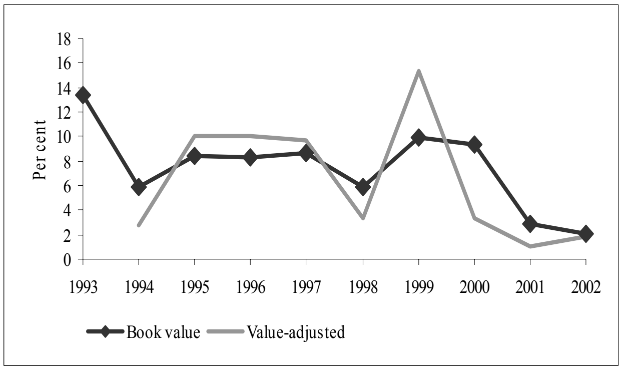
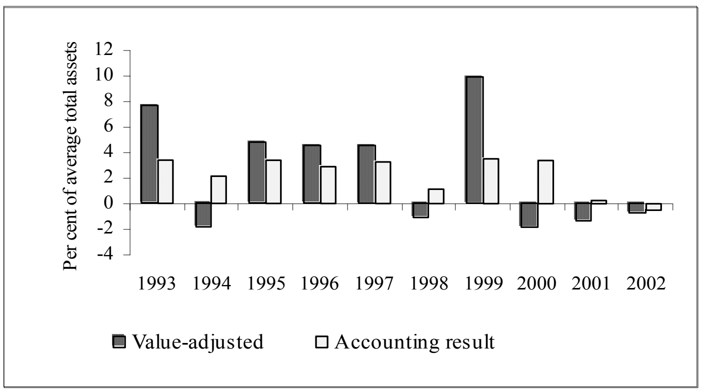


Chart 2.14: Life insurance companies' results



Whereas life insurance companies' overall shareholding fell steeply in 2002, their holding of bonds held to maturity rose by 13 percentage points to reach 32 per cent of total assets at the end of 2002.

At the end of 2002 life insurance companies' capital adequacy averaged 16.9 per cent, and all companies met the capital adequacy requirements of 8 per cent. At the start of the year capital adequacy averaged 13.2 per cent. The improvement is related to the companies' reallocation from shares to bonds which has reduced the basis for capital adequacy calculation. The improvement says little about the companies' ability to bear market risk. All life insurance companies complied with the solvency margin requirement.

Chart 2.15: Trend in life insurance companies' balance sheet

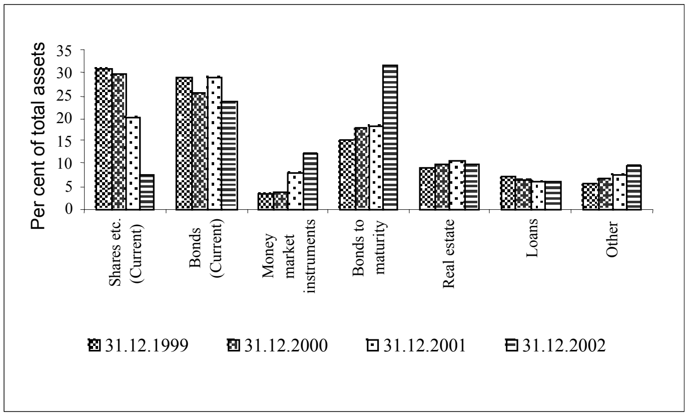
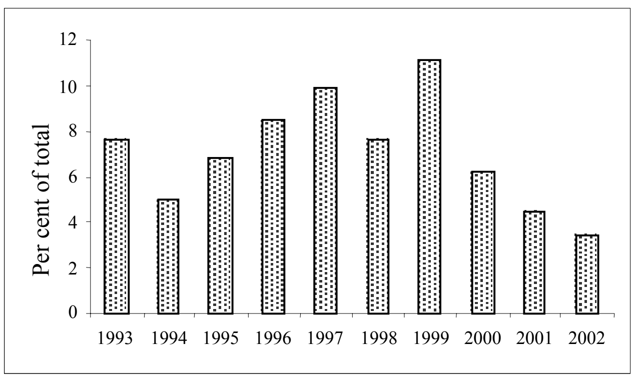


Chart 2.16: Trend in life insurance companies' buffer capital
(as a per cent of total assets)



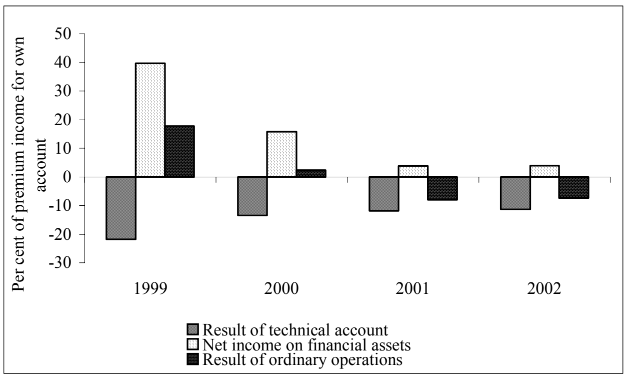
The share market fall has brought a significant weakening of life insurance companies' aggregate buffer capital. At the end of 2002 buffer capital - comprising excess core capital, supplementary provisions limited to a maximum of one year's interest guarantee and fluctuation reserves – came to NOK 14.2 billion or 3.4 per cent of the companies' total assets. This is the lowest year-end level in the past ten years. At end-2001 buffer capital totalled NOK 18.0 billion or 4.5 per cent, compared with NOK 40 billion or 11 per cent of total assets at end-1999.

Non-life insurance companies

Non-life insurance companies reported an overall loss of NOK 1.4 billion on ordinary operations in 2002 compared with a loss of NOK 1.3 billion in 2001. Both the technical result and net financial income were at approximately the same level as in 2001. Since the companies substantially reduced their share component in the second quarter of 2002, the share market fall had a smaller impact on results in the second half-year.

After some years of very weak technical results the companies substantially raised premiums in 2000 and 2001. This has markedly improved the claims ratio (claims as a per cent of premium income for own account) and the expense ratio (insurance-related operating expenses as a per cent of premium income for own account) in recent years. For non-life insurance companies as a whole, the claims ratio fell from 85.8 in 2001 to 81.2 in 2002. Despite appreciable growth in expenses the expense ratio fell from 24.3 in 2001 to 23.6 in 2002.

Chart 2.17: Non-life insurance companies' results



Allocated investment return is omitted from the result of the technical account.

Apart from one company, all non-life insurance companies met the capital adequacy requirement at the end of 2002. The company in question subsequently increased its capital to restore compliance with the statutory minimum requirement. Non-life insurance companies' aggregate capital base came to NOK 6.7 billion at the end of 2002. All non-life insurance companies complied with the solvency margin requirement.

3. Risk areas

Credit risk

Credit risk is the most significant risk facing Norwegian banks. Credit risk includes both the likelihood of a counterparty being unable to honour its obligations and the loss it incurs in that event, account being taken of the value of any security held by the bank.

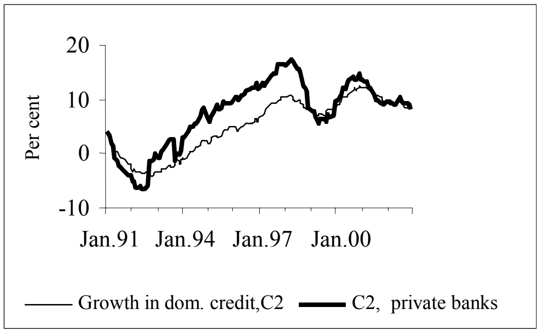
While growth in credit to enterprises has slowed in the past two years, growth in credit to households, related partly to the trend in the housing market, continued at a very high level in 2002. Households' and non-financial institutions' debt-servicing capacity has weakened in recent years. In 2002 Kredittilsynet carried out surveys of banks' exposure to, and their risk assessment of, certain industries and in the home financing sector. Vigorous growth in lending by a number of banks in the second half of the 1990s set the stage for increased credit risk. Rapid credit growth clearly places a premium on good risk management and control systems. While the Finance Credit scandal appears to be largely due to fraud perpetrated on Norwegian banks, and to be a one-off occurrence, the affair emphasises the necessity of sound credit assessment routines. With the weaker economic climate of the past two years, and growing problems, especially in Norway's exposed sector, bank losses rose markedly in 2002. Inspections show that credit risk at most banks, including the large ones, has increased.

Credit growth

In 2002 banks' lending growth fell to a markedly lower level than that witnessed in the second half of the 1990s. At end-2002 banks' credit growth stood at 8.3 per cent, whereas at its peak in the 1990s (in March 1998) it stood at 17.5 per cent. Strong growth in lending to households over a long period has led to a rise in the share of loans to the retail market compared with loans to the business sector. At the end of 2002 more than half of bank loans went to the retail market.

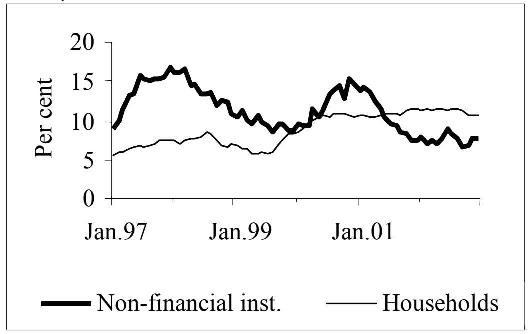
Although credit growth both overall and from banks has slowed, it remains at a relatively high level. A number of small and medium-size banks continue to lend at a rapidly expanding rate. Table 3.1 breaks down the bank sector by lending growth and level of core capital. At the end of 2002 38 banks' lending growth exceeded 15 per cent. These are for the most part smaller banks, together making up about 5 per cent of aggregate total assets in the banking market. Four of them had core capital of less than 10 per cent. Lending growth slowed from 2001 to 2002. Due to weak results, core capital adequacy was also reduced.

Chart 3.1: Growth in domestic credit and in credit from private banks



Source: Norges Bank

Chart 3.2: Growth in credit to households and enterprises



Source: Norges Bank

The great majority of banks report lending growth of just over 6 per cent, and overall core capital adequacy of about 11 per cent. The three largest banks, which are of greatest significance for stability in the banking market, showed low overall growth at the end of 2002, and lower growth than in the previous year. Core capital adequacy was close to 9 per cent at the same point.

Table 3.1: Banks distributed by growth in lending and core capital adequacy. Per cent

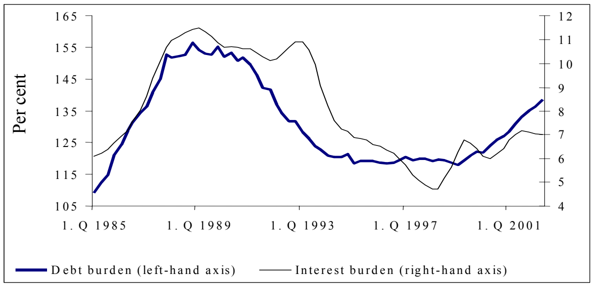
	Growth in lending to non-financial private sector over past 12 months		Core capital adequacy		Share of total assets	No. of banks
	2002	2001	2002	2001		
Three largest banks	6.0	10.1	8.7	8.5	57	3
Banks with lending growth below 15 %	6.3	9.4	10.9	11.0	38	101
Banks with lending growth above 15 %						
Core capital adequacy above 15 %	17.9	33.9	19.9	21.7	1	18
Core capital adequacy 10–15 %	19.7	27.9	12.2	14.8	2	16
Core capital adequacy below 10 %	16.6	23.9	8.8	9.4	2	4

* Recently established banks not included

Households

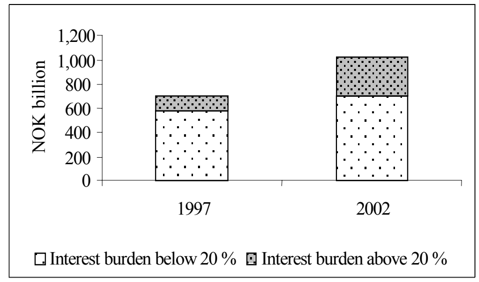
Households' gross indebtedness has risen substantially in the past four years, in part due to high activity in the housing market and sharp growth in housing prices. Figures for the first two quarters of 2002 show that while households' debt burden continued to rise, it was nevertheless lower than in the mid-1980s. Despite their high debt incurrence, households' average interest burden remained almost unchanged in the first half of 2002 due to some-what lower interest rates. Although growth in credit to households edged down, it remained at a high level at the end of December 2002. With a substantial increase in disposable income in the wake of favourable wage rounds, most house-holds will nonetheless manage to service the increased debt burden, even if higher electricity prices lay claim to part of the income growth. Norges Bank's two interest rate cuts at around the end of 2002 also augur a reduced interest burden.

Chart 3.3: Household debt and interest burden as interest a per cent of disposable income



Sources: Norges Bank and Statistics Norway

Chart 3.4: Household debt distributed by burden



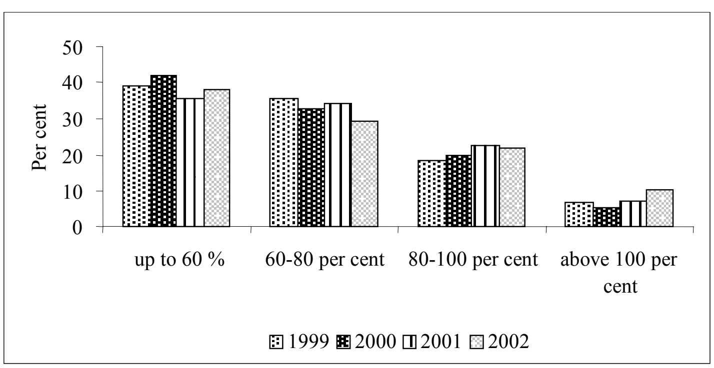
Sources: Norges Bank and Statistics Norway

Despite the substantial reduction in households' financial wealth as a share of disposable income in the past two years, households are in a significantly higher wealth position than at the end of the 1980s. However, there is large spread among households, with households whose interest outlays equal more than 20 per cent of disposable income accounting for a growing share of overall indebtedness, as shown in table 3.4. Hence some groups may find themselves in a very vulnerable financial position in a period of weaker business conditions and rising unemployment.

Home mortgage loans

The bulk of bank loans to the retail market are mortgage loans secured on residential property. Kredittilsynet has since 1994 conducted annual surveys of banks' lending practice as regards home mortgage loans. The 2002 survey shows that the share of reported loans in excess of 80 per cent of property valuation rose from 30 per cent of the portfolio in 2001 to 32.5 per cent in 2002. The portfolio share of loans with a high loan-to-value ratio (over 80 per cent) is increasing in the case of savings banks and falling in the case of commercial banks. For savings banks the portfolio share of this type of loan is 35 per cent while for commercial banks the figure is 29 per cent. There are wide variations between banks as regards loan-to-value ratio.

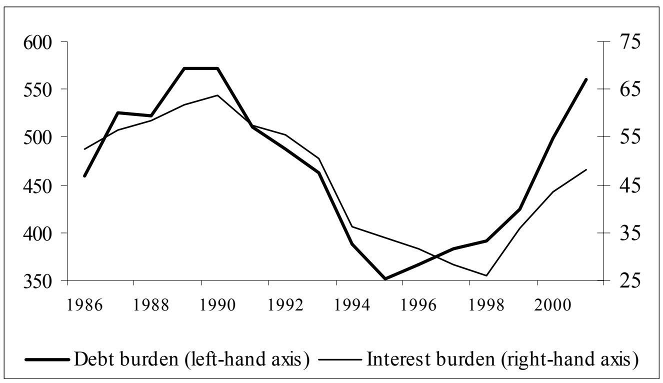
Chart 3.5: Share of home mortgage loans in various loan-to-value categories 1999–2002



Enterprise sector

Non-financial enterprises also significantly increased their debt incurrence in the economic upturn. This involved a sharp rise in investments motivated by high activity levels and good prospects for the future. Enterprises' debt burden started to rise as far back as the mid-1990s, and for mainland businesses the increase has been particularly marked since 1998. This development is due both to the fact that mainland industries accounted for much of the steep debt build-up in the period, but also to the trend in earnings. Despite slower debt growth in 2001, mainland enterprises' debt burden increased to about the same level as at the end of the 1980s. Since 1997 enterprises' debt burden has risen sharply both as a result of higher indebtedness and of rising interest rates and lower earnings. Accounting figures for 2001 show a significant decline in mainland enterprises' profits.

Chart 3.6: Mainland enterprises' debt and interest burden



Sources: Norges Bank and Statistics Norway

A total of 4,473 bankruptcy proceedings were instituted, an increase of 26 per cent from 2001 to 2002. Lower profits and impaired financial positions, along with expectations of a weaker trend in competitively exposed industries, suggest difficulties for more enterprises and regions ahead. Problems in parts of the sheltered sector and spillover effects to the real estate sector have led to increased vulnerability across the enterprise sector as a whole.

Kredittilsynet analysed the trend in some banks' business sector portfolios in 2002 as part of its inspection activity. The analyses are based on Norges Bank's credit risk model which indicates bankruptcy probability based on age, size, industry characteristics and accounting variables that shed light on the individual enterprise's earnings, liquidity and financial strength. The model predicts the likelihood of an enterprise going bankrupt within three years of the point in time the analysis was made. The analyses show that credit risk rose in 2002. This tallies with the banks' own portfolio overviews. Most larger banks' overviews show a deterioration of portfolio quality in 2002.

Exposure to selected industries

Each year since 1998 Kredittilsynet has investigated banks' exposure to selected industries. The 2002 survey covered shipping, the shipbuilding industry, offshore industry, extraction of oil and gas, fish farming and property management. The 12 largest banks are included, and the analysis is based on the banks' own risk assessments and classifications. Weaker economic conditions and impaired results in many sectors contributed to the increase – in all surveyed industries apart from the offshore industry – in the share of utilised commitments classified as high risk in the third quarter of 2002 compared with the third quarter of 2001. Property management was the industry to which the banks had lent most, closely followed by shipping. Five to six per cent of utilised commitments in both sectors were classified as high risk. The strongest increase in the high-risk share was in the fish farming industry, where over-production and appreciably lower prices cut back profits. High exposure to the real estate sector, with much spare capacity in the office segment and a weak trend in rental prices, is likely to lead to a deterioration of banks' loan portfolios ahead.

Table 3.2: Banks' exposure to selected industries as at the third quarter of 2002

Industry	Loan commitments		Amount drawn	High risk as % of amount drawn	
	NOK billion	Ann. growth Per cent	NOK billion	30.09.2001	30.09.2002
Shipping	103.3	-15.8	81.6	3.7	5.3
Shipbuilding	12.7	-17.5	7.5	6.2	14.5
Offshore	13.8	3.0	8.0	41.6	12.4
Oil/gas extraction	31.5	4.7	11.3	2.9	3.2
Fish farming	15.0	3.5	13.6	2.7	38.6
Property management	126.9	---	106.3	---	6.2

Loans secured by financial instruments

Banks can provide loans to households and businesses to finance securities where the securities themselves constitute the collateral. Since 1997 Kredittilsynet has conducted annual surveys of loans secured by financial instruments and banks' treatment of such loans. Twenty-four institutions participated in the 2002 survey. The volume of loans secured by financial instruments is low in Norway compared with other countries, although it has risen in recent years. In 2001 loans secured by financial instruments levelled off, and from the third quarter of 2001 to the third quarter of 2002 they fell sharply from NOK 30.7 billion to NOK 25.2 billion, due to falling share markets. This type of loan as a share of total lending fell from 3.1 per cent to 2.5 per cent. In 2001 the volume of payment problems and losses related to loans secured by financial instruments was on a low trend, but rose from 2001 to 2002.

Finance Credit

Several medium-size Norwegian banks incurred significant losses in the wake of the collapse of the Finance Credit system. Under Norwegian law Finance Credit was not a financial institution, and was not subject to Norwegian supervision. One of its operations was a branch of a Swedish finance company under the supervision of the Swedish supervisory authorities. Two companies in the Finance Credit system were licensed debt collection agencies and were therefore under Kredittilsynet's supervision. One of them has continued its operations. Ordinary debt collection customers do not appear to have lost money due to the collapse of the Finance Credit system. The auditor's role in the Finance Credit system is under investigation by Kredittilsynet. In November 2002, loans extended by financial institutions under Kredittilsynet's supervision to companies in the Finance Credit system totalled in the region of NOK 1.45 million. The largest lender was Nordlandsbanken ASA. Preliminary figures show that banks have booked losses in excess of NOK 1.3 billion on Finance Credit. Several circumstances related to Finance Credit are still under investigation. Loans to companies in the Finance Credit system were among the issues raised during routine inspection visits to Nordlandsbanken, Bank 1 Oslo and Sparebanken Øst in 2002. None of these banks reported any risk of loss on their commitments.

Both Kredittilsynet's supervision and the banks' own explanatory accounts and investigatory reports brought to light flaws in the credit treatment employed by the banks involved. Although the banks that had extended loans to Finance Credit were evidently misled by deficient accounts, they do not appear to have conducted a sufficiently thorough and critical review of the information available to them. Consolidated accounts were neither examined nor analysed. Substantial flaws were uncovered in the way the banks monitored their commitments and checked the assumptions on which their loan disbursements were based. The security interest of all lenders, except one, rested exclusively in outstanding claims, shares in companies within the Finance Credit system or guarantees from owners/companies within that system.

Bank losses

Loss levels for the banks as a whole were moderate up to and including 2001, primarily thanks to very low losses among the largest banks. In 2002 some medium-size and smaller banks incurred substantial losses. Losses unrelated to the Finance Credit system also rose in 2002.

Several banks incurred substantially higher losses in 2002 than in 2001, primarily related to Finance Credit. Twelve banks had losses in excess of 1 per cent of loans in 2002. Combined losses for these banks totalled 3.12 per cent. The three largest banks, whose aggregate losses measured 0.39 per cent of their overall loans, are not included in Chart 3.7.

Chart 3.7: Banks' total assets distributed by loan losses: 2001 and 2002

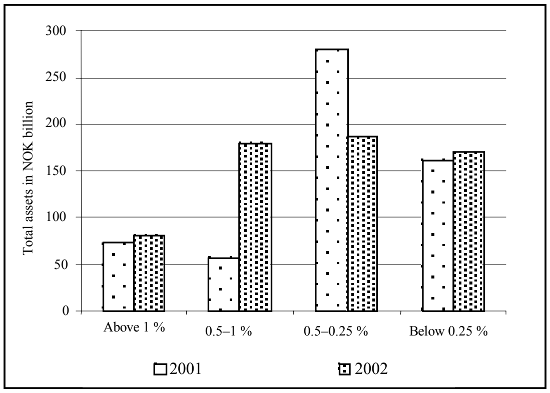
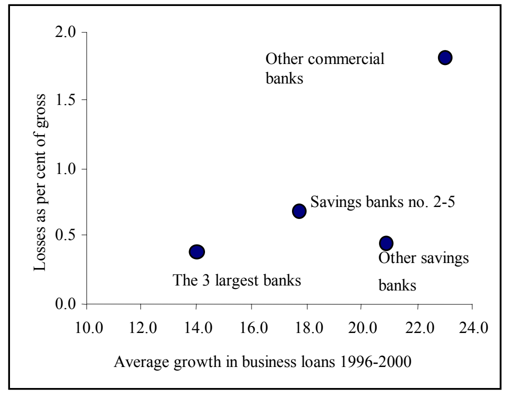


Chart 3.8: Losses (2002) and growth in enterprise loans (1996–2000): Categories of banks



Both households and enterprises have seen their debt vulnerability rise in recent years. Losses in 2002 were essentially related to enterprise sector commitments. Chart 3.8 shows overall growth in lending to this segment in 1996–2000 and booked loan losses in 2002. The period 1996–2000 featured economic recovery and rapid credit growth, while loss levels have risen in the past two years of weaker economic conditions. Whereas the three largest banks showed lowest growth during the upturn and lowest losses in the ensuing period, the category "other commercial banks" recorded both the quickest growth and heaviest losses in 2002.

The credit risk to which a bank is exposed is related both to institution-specific factors and factors affecting the industry as a whole. Weaker economic conditions and the problems related to industry structure that have contributed to a strong increase in business failures and other problems in manufacturing industry suggest that the loss increase is of a general character, albeit related to differing exposures to various industries. This is already reflected in a generally higher loss level for the banking sector as a whole. Credit risk has increased at most banks inspected by Kredittilsynet. The three largest banks' own measures of portfolio quality show that credit risk has increased in these institutions as well. Hence the loss trend in 2002 reflects not only losses caused by institution-specific factors; it also suggests a generalised increase in losses in the Norwegian banking sector.

Market risk

While Norwegian banks in general only to a certain extent are directly exposed to market risk, insurance companies incur substantial direct exposure to market risk. Norwegian fixed income and share markets are significantly affected by international developments. Co-variation between national markets appears to be strongest in bear markets. In recent years markets appear to be exposed to a larger number of extreme events and shocks than previously. At the same time the spillover effects between national markets are more strong and feed through more rapidly.

Banks

Banks' exposure to market risk is negligible since a minimal part of their total assets is invested in securities affected by market volatility. Preliminary figures show that the three largest banks invested 0.5 per cent of their total assets in shares at end-2002, while 8.4 per cent was invested in fixed income securities. The portion invested in shares by the other banks was also low, totalling 1.1 per cent of their total assets at the same point in time. Although total bank losses on shares were negligible in 2002, some banks incurred losses on their shareholdings. Banks' fixed income investments accounted for 6.2 per cent of their total assets. However, falling share markets impair the safety of bank loans secured on securities (cf. discussion under "Credit risk").

Life insurance companies

Among Norwegian financial institutions, life insurance companies are those with highest exposure to market risk. In 2002, however, the risk picture changed as a result of portfolio reinvestment. At year-end 7.3 per cent of life insurance companies' total assets held as current assets was invested in shares, the lowest level for ten years.

Chart 3.9: Life insurance companies' holdings of shares and fixed income securities

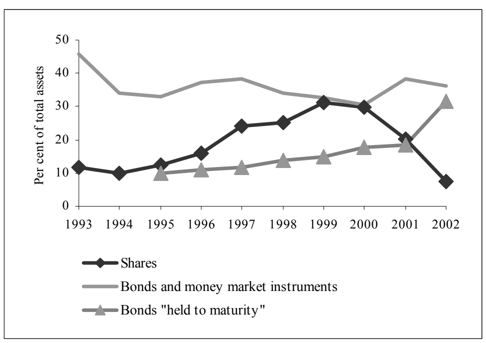
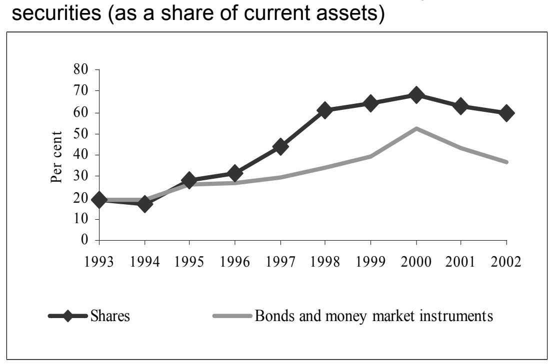


Chart 3.10: Life insurance companies' foreign securities (as a share of current assets)



Life insurance companies increased their share investments sharply in the second half of the 1990s, but reversed this trend in 2000. The decline was particularly marked in 2002. Their investments lost significant value, and they have been compelled to disinvest to adjust their exposure to a weaker risk-bearing capacity.

Life insurance companies' holdings of bonds classified as "bonds held to maturity" rose substantially in 2002. At year-end these companies' overall holding of such bonds came to NOK 130 billion, or 31.5 per cent of their aggregate total assets. This is NOK 58 billion or 13.2 percentage points more than at the end of 2001. About two-thirds of the bonds involved mature after 2005. Concurrently the companies have marginally reduced the share of money market instruments and bonds held as current assets. Market risk has been reduced in the short term. While companies are now less exposed to market risk from share markets, they have become more dependent on interest rates.

Table 3.3: Holding as at 31.12.2002 of bonds classified as “held to maturity”. Per cent

	Maturing in 2003	Maturing in 2004	Maturing in 2005	Maturing after 2005	Total
Per cent of total assets	2.3 %	4.9 %	3.2 %	21.0 %	31.4 %
Average interest rate	6.2 %	5.8 %	6.3 %	6.2 %	6.1 %

“Average interest rate” means interest taken to income (incl. accrued premium/discount) as a per cent of the holding maturing in the period in question

Life insurance companies substantially increased their foreign share component from the mid-1990s onwards. Investments in foreign fixed income securities also increased in the same period, albeit by a somewhat smaller margin than in the case of shares. Since the peak in 2000 the portion of investments in foreign shares and fixed income securities has declined, probably due to the uncertain outlook for the global economy and high Norwegian interest rates. The foreign share component was 60 per cent at the end of 2002.

Reduced share investment among life insurance companies is not a specifically Norwegian phenomenon. The same trend is in evidence in most European countries, although the reduction has generally been smaller than in Norway. The decline has been greatest in countries with the highest share component, and in countries where valuation of shares at market value is mandatory. In the latter countries, the reduced share component reflects both value loss and disinvestment.

Life insurance companies’ buffer capital

At the end of 2002, life insurance companies’ buffer capital totalled NOK 14.3 billion, or 3.4 per cent of their aggregate total assets (cf. also Chapter 2). Both Kredittilsynet and the companies employ stress tests to assess the companies’ ability to withstand sudden, unfavourable market movements. Two stress tests, with a basis in the companies’ buffer capital as at 31.12.2002, are illustrated below. They contain no information on the likelihood of the scenarios actually materialising.

Scenario 1 employs the following assumptions: a 20 per cent fall in the Oslo Børs All-Share Index; a 20 per cent fall in corresponding indices in international share markets; no change in interest rates in Norwegian or international fixed income markets.
Scenario 2 employs the following assumptions: a 20 per cent fall in the Oslo Børs All-Share Index; a 20 per cent fall in corresponding indices in international share markets; a 1 per cent rise in interest rates in Norwegian and international fixed income markets.

The stress tests show that fixed income markets are now of greater significance for life insurance companies than share markets. All companies have buffer capital sufficient to withstand scenario 1. In the case of scenario 2 one company will incur a loss on its securities portfolio in excess of its buffer capital at the start of 2002. However, there is currently no significant likelihood of a substantial increase in Norwegian and international long interest rates. The focus of these stress tests is on the short-term impacts of higher interest rates via price loss on holdings. In the longer term an increase in long rates will in isolation have a favourable effect on the companies' results. Stress tests do not include real estate.

Table 3.4: Stress tests for life insurance companies as at 31.12.2002

31.12.2002	Buffer capital before stress test	Value fall in stress scenario				Buffer capital after stress test
		Shares		Bonds		
NOK million		Norwegian	Foreign	Norwegian	Foreign	
Scenario 1	14 274	-2 221	-3 228	0	0	8 826
Scenario 2	14 274	-2 221	-3 228	-1 584	-2 788	4 454

Non-life insurance companies

Non-life insurance companies have also been relatively heavily exposed to market risk. At the end of 2002 6.7 per cent of non-life insurance companies' total assets was invested in shares (classified as current assets), significantly down from 17.8 per cent one year earlier. Non-life insurance companies have concurrently increased the portion of total assets invested in bonds and money market instruments. Total holdings of bonds and money market instruments measured 49.2 per cent of total assets at the end of 2002, of which 6 per cent comprised bonds held to maturity. Holdings of bonds and money market instrument totalled 39.7 per cent at the end of 2001.

Insurance risk

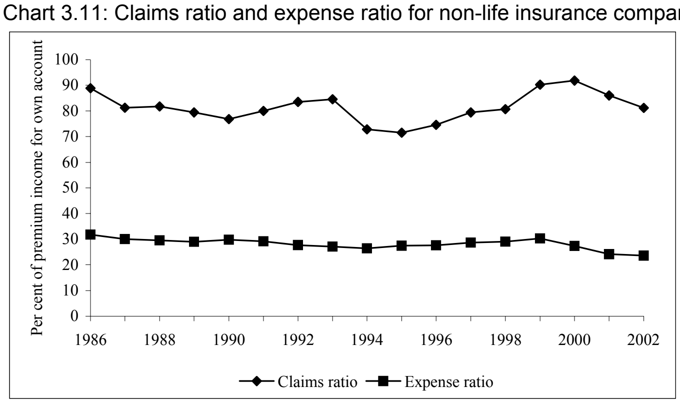
Insurance risk refers to the varying balance over time between claims and other insurance-related expenses on the one hand, and premium income on the other. The main cause of insurance risk is that claims payments prove higher than was assumed when the premium levels were set.

Short-term insurance risk is higher in non-life insurance than in life insurance. Single events can lead to high claims for non-life insurance companies, at the same time as the number of claims and payments per claim can vary. Hence non-life insurance companies are in greater need of a continual reserve of buffer capital measured as a percentage of total assets. Maximum payment per claim are normally comparatively limited for life insurance companies, at the same time as the trend in the number of incurred claims and associated disbursements are more predictable from year to year. Above all, the trend in mortality is stable, while the trend in disability is more uncertain. Companies have recently been compelled to increase their provisions for disability insurance.

The very weak technical results in the years following 1998 reflect the substantial insurance risk present in non-life insurance. The growth in claims far exceeded growth in premium income, requiring companies to substantially increase premiums in 2000 and 2001. As shown in Chart 3.12, the claims ratio (claims as a per cent of premium income) has varied considerably. The expense ratio (insurance-related operating expenses as a per cent of premium income) has also varied, but has shown a falling trend over time.

For Norwegian non-life insurance companies, purchasing reinsurance is a main element of insurance risk management. Life insurance companies normally employ reinsurance exclusively for catastrophe coverage, and the reinsurance portion is negligible compared with that employed by non-life insurance companies. Norwegian non-life insurance companies purchase the great majority of their reinsurance from major foreign reinsurance companies, and are thus dependent on the trend in the international reinsurance market. After some years of low prices and favourable conditions, prices have shown a substantial rising tendency in recent years. This will weaken results for Norwegian non-life insurance companies, both via higher reinsurance costs and via lower reinsurance cover with an ensuing increase in claims.

Chart 3.11: Claims ratio and expense ratio for non-life insurance companies 1986–2002



Liquidity risk

For banks, liquidity risk arises due to a mismatch between the maturity on their loans and other claims and the maturity on their funding. Reducing the maturity on banks' funding will normally increase liquidity risk. A high level of short-term financing by banks' creates a high current refinancing requirement. This makes banks more vulnerable to weakened earnings and financial strength, and to any general tightening of market liquidity.

Customer deposits are regarded as a stable source of finance for banks. Although bank loans are still mainly financed by customer deposits, the loan-to-deposit ratio has for some time been on a falling trend since households are opting to greater degree for other saving mediums. The trend stabilised somewhat in 2002 due to a continued fall in share markets.

Due to their declining loan-to-deposit ratio, banks have grown more dependent on funding via the money and capital markets. Both short-term and long-term funding (bonds, customer deposits and equity capital) have been stable in relation to loans. Bank lending growth has been strong since 1997, and the scale of short-term funding is therefore large. Foreign funding is also substantial. There are however wide variations among the banks.

Some portions of customer deposits may be somewhat less stable than other portions. Due to banks' compulsory membership of the guarantee funds, deposits up to the level covered by the guarantee schemes (i.e. NOK 2 million) are a "risk-free" investment option for customers. Chart 3.14 shows that deposits above NOK 2 million (both by customers and other credit institutions) constitute a large share of banks' total deposits, especially the largest banks and the category of other commercial banks.

Chart 3.12: Short-term funding as a per cent of net loans

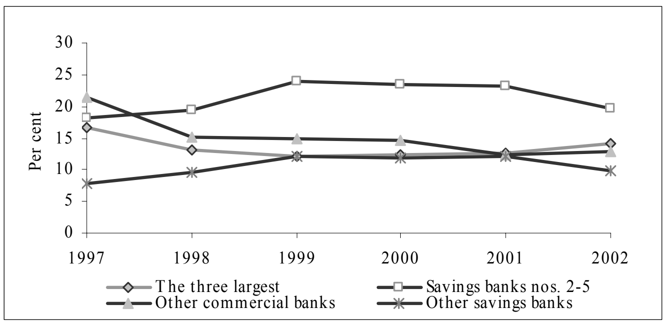
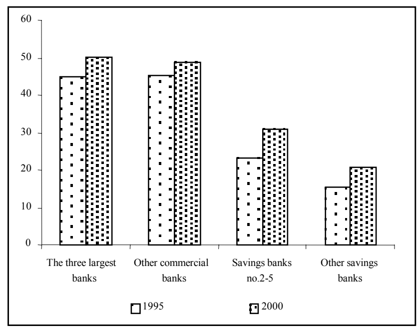


Chart 3.13: Deposits > NOK 2 million as a per cent of total deposits



Surveys of bank liquidity

In the autumn of 2002 Kredittilsynet conducted a survey of the eleven largest Norwegian banks' management and control of liquidity risk. The survey was based on internationally recognised principles in the field. Each bank received feedback on any improvements that could be made. Banks are in general giving increasing emphasis to liquidity risk and management of liquidity risk. The survey brought to light substantial differences in terms of the degree of long-term funding.

In the fourth quarter of 2002 there were signs of deteriorating liquidity at some banks. With this in mind, Kredittilsynet examined in December the liquidity position of a number of Norwegian banks. Nineteen were selected on the basis of detailed criteria, with the emphasis on somewhat larger banks. The investigated banks either had a weak financial position, impaired earnings as a result of heavy losses or generally weak operations, or high liquidity risk. The survey showed that refinancing of short-term debt was more difficult and associated with higher costs for these banks than for others. Moreover, some contended that funding appeared to be more difficult in the domestic market than in the foreign market. The banks largely employed surplus liquidity and drawing facilities to meet their funding requirements in November and December 2002, thereby reducing their liquidity buffers. It emerged that the banks themselves expect greater differentiation between banks ahead with regard to refinancing opportunity. Size, rating, financial strength and profitability will be significant factors here.

The survey showed substantial differences between banks as regards actual liquidity risk. Some were in a difficult funding situation at the time of the survey. Others did not face serious liquidity problems up to year-end, but had substantial refinancing needs early in 2003. Most of the investigated banks do not appear to have significant liquidity problems in the short and medium term. Those that are most exposed are monitored by Kredittilsynet on a continual basis. The liquidity position of some of the most exposed banks appears to have improved somewhat since year-end.

Operational risk

In recent years increased international attention has focused on operational risk, or the risk of financial loss as a result of deficient internal controls, human error or fraud, disruption/flaws in IT systems or other systems in institutions, or external events. Deficient expertise, ethics and attitudes have often been at the root of major financial losses incurred by institutions. Operational risk has risen in step with rapid technological evolution and the introduction of increasingly complex financial products and organisation structures.

Since Norwegian banks have not systematically registered losses due to operational deficiencies, it is difficult to establish the historical scale of such losses in the Norwegian bank sector. While such losses are not likely, in isolation, to significantly increase systemic risk, operational risk could lead to substantial losses for individual banks.

Supervision of investment firms and management companies focuses on their routines, guidelines, authorisation structure, IT systems, and the competence possessed by the institution. An assessment is also made of the institution’s preparedness for extreme outcomes with potentially substantial consequences for investors and possibly for the institution’s continued existence.

Is there a danger of a new banking crisis?

A feature common to many banking crises, also in the Nordic region, has been rapid debt growth and inflated prices in real estate and securities markets in the run-up to the crisis. While a crisis can be triggered by a variety of factors, it often coincides with an economic downturn accompanied by an impairment of households’ and enterprises’ ability to service debt.

At the start of 2003 Norway faces a situation coloured by a highly uncertain outlook for the international economy. International uncertainties are affecting the Norwegian economy. An economic setback has followed a period of strong domestic activity levels, rapid growth in credit and real estate markets and growing private sector indebtedness.

Both credit growth and the trend in real estate markets have been somewhat weaker than was the case in the 1980s. However, credit growth is far higher than the growth rate in the economy would suggest, and real housing prices are 22 per cent higher than in the peak year 1987. Commercial property values have fallen, and real prices are far below the highest prices witnessed at the end of the 1980s. Nominal prices are also somewhat below the level at that time. Hence there is less danger of a fall in property prices as dramatic as that seen at the start of the 1990s. Households' and enterprises' indebtedness has risen in recent years. However, the household sector is now in a better situation overall than in the 1980s. Where the business sector is concerned, indebtedness is approaching the 1980s level, although the rate of debt increase has slowed in recent years. Interest rates have fallen of late, whereas the situation at the end of the 1980s suggested that rates would rise.

A strong balance of payments and sound central government finances make a serious setback in the Norwegian economy unlikely. Reorientation of monetary policy has reduced the risk of a steep interest rate increase coinciding with rising unemployment and falling real estate markets. However, the situation in parts of the exposed sector is problematic. Although bank profits weakened in 2002, core capital adequacy held up well for the banks as a whole. The banking sector's overall equity capital situation is stronger now than it was in the 1980s and the three largest banks' core capital adequacy is close to 9 per cent, the highest ever. Most other banks are also in a financially sound and liquid position. Hence there is little likelihood of serious problems affecting the majority of the Norwegian banking sector in the year immediately ahead. However, some small and medium-size banks may face substantial challenges, particularly if the current weak cyclical trend continues.